

**THE INTERNATIONAL ASPECTS OF THE EUROPEAN COMMON  
CONSOLIDATED CORPORATE TAX BASE (CCCTB) AND THEIR  
INTERACTION WITH THIRD COUNTRIES**

A thesis submitted for the degree of Doctor of Philosophy

by

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## ***ABSTRACT***

The thesis examines the international taxation rules of the Common Consolidated Corporate Tax Base (CCCTB) and their interaction with third-country corporate tax practice. The aim is to assess the effectiveness of the CCCTB vis-à-vis third countries, with Egypt as a practical example.

The CCCTB has the potential to reduce corporate tax obstacles faced by businesses in the EU in having to comply with up to twenty seven different domestic systems for determining their taxable profits. However, the international taxation rules of the CCCTB system are likely to have an impact on the corporate tax practice in third countries, and may conflict with existing bilateral tax treaties concluded between CCCTB-Member States and third countries.

The discussion presents a detailed analysis of the CCCTB's unilateral framework for the avoidance of double taxation and for the protection of the common consolidated tax base. It reveals that, by means of ordinary credit and exemption methods provided in the CCCTB Directive, international double taxation will be eliminated in relation to third countries. Furthermore, the CCCTB's anti-abuse rules are effective in protecting the common tax base and in eliminating non-double taxation. Nevertheless, the unilateral measures are in conflict with a number of important provisions of bilateral tax treaties, based on the OECD Model, concluded between the potential CCCTB-Member States and third countries. Egypt exemplifies this – but the problem is generic. These conflicts between the CCCTB and OECD Model bilateral treaties are detrimental to the effective functioning of the CCCTB system vis-à-vis third countries, and need to be redressed.

This thesis suggests a simple and practical solution - replacement of the bilateral tax treaties between CCCTB-Member States and third countries with a multilateral tax treaty to be concluded between every third country and all CCCTB-Member States.

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## *LIST OF ABBREVIATIONS*

AA	Association Agreement
AMU	Arab-Maghreb Union
BITs	Bilateral Investment Treaties
CCCTB	Common Consolidated Corporate Tax Base
CFC	Controlled Foreign Corporation
CPM	Cost Plus Method
CSCE	Conference on Security and Cooperation in Europe
CUP	Comparable Uncontrolled Price
DCFTAs	Deep and Comprehensive Free-Trade Agreements
ECJ	European Court of Justice
EEC	European Economic Community
EIB	European Investment Bank
EMP	Euro-Mediterranean Partnership
EMU	European Monetary Fund
ENP	European Neighbourhood Policy
ETA	Egyptian Tax Authority
EU	European Union
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
GAAP	General Accepting Accounting Principles
GAAR	General Anti-Avoidance Rules
GAFI	General Authority for Investment
GMP	Global Mediterranean Policy
GST	General Sales Tax system
IIT	Individual Income Tax

MENA	Middle East and North Africa
MFN	Most Favoured Nation
MTC	Multistate Tax Compact
OECD	Organisation for Economic Co-operation Development
PSM	Profit Split Method
RMP	Renovated Mediterranean Policy
RPM	Resale Price Method
SME	Small & Medium-Sized Enterprise
TFEU	Treaty on the Function of the European Union
TNMM	Transactional Net Margin Method
TPD	Transfer Pricing Division
UN	United Nations
VAT	Value Added Tax
VCTL	Vienna Convention on the Law of Treaties
WTO	World Trade Organization

## 1 Introduction

### 1.1 Background

Insofar as the European economic integration has greatly accelerated,<sup>1</sup> Member States' tax systems, including both direct and indirect taxation, needed to be reformed in order to be accommodated to the economic development in the EU.<sup>2</sup> With respect to indirect taxation, Value Added Tax (VAT) has been harmonised through a number of Directives.<sup>3</sup> In addition, customs taxes have reached a very high level of harmonisation.<sup>4</sup> Direct taxation is arguably more important than indirect taxation as it affects *inter alia* investment, establishment and employment decisions.<sup>5</sup> However, a close look at corporate taxation in the EU reveals a great diversity; this in turn gives rise to significant distortion regarding cross-border businesses within the EU. Corporate taxation diversity influences business location and Foreign Direct Investment (FDI)

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<sup>1</sup> Dagmar Schiek, *Economic and Social Integration: The Challenge for EU Constitutional Law*, (Edward Elgar Publishing Limited 2012), p.13 et seq; Paulus Merks, 'Corporate Tax and the Global Village', *Intertax*, Vol. 34, Issue 1, 2006, pp.26-31, at 28; Sijbren Cnossen, 'How Much Coordination in the European Union', *International Taxation and Public Finance*, Vol.10, 2003, pp.625-649.

<sup>2</sup> Jack M. Mintz, 'Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake' (Oxford University Centre for Business Taxation, WP 07/14, 2007), p.9; Philippe de Buck, 'How the CCCTB can Attract the Interest and the Support of the Business Community', *World Commerce Review*, June 2011, p. 16.

<sup>3</sup> Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes, OJ 71, 14/04/1967, 1301; Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes – Structure and procedures for application of the common system of value added tax, OJ P71, 14/04/1967, 1303; Council Directive 77/388/EEC of 12 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: Uniform basis of assessment, OJ L145, 13/06/1977, 1; Council Directive 86/560/EEC of 17 November 1986 the refund procedure for taxable persons not established in the territory of the country, OJ L 326, 21/11/1986, 40 and Council Directive 2002/38/EC of 7 May 2002 regarding the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ L 128/41, 15.5.2002, 41. For more on VAT harmonisation see Rita de la Feria, 'VAT and the EC Internal Market: The Shortcomings of Harmonisation' Oxford University Centre for Business Taxation WP 09/29, 2009); for a brief assessment of VAT in the EU see Michel Aujean, 'Harmonization of VAT in the EU: Back to the Future', *EC Tax Review*, March 2012, pp.134-143.

<sup>4</sup> For example, Arts. 28, 30 and 31 of the Treaty of the Function of the European Union (TFEU) provides for a custom unification, the prevention of intra-community customs duties and the establishment of a common custom tariff vis-a-vis third countries. Moreover, custom tax consolidation has been achieved through introducing Community Customs Codes such as Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code, OJ L 302, 19.10.1992, p. 1; Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92, O J L 253, 11/10/1993 p.1; Council Regulation (EC) No 824/2007 of 10 July 2007 OJ L 184/1 14.7.2007,p1. For more on European Tax Integration see Jan de Goede, 'European Integration and Tax Law', *European Taxation*, (IBFD June 2003), pp.23-209.

<sup>5</sup> Ben.Terra, *European Tax Law* (Kluwer Law International 2008), p.239.

since the differentials of corporate tax play a major role in driving FDI flows.<sup>6</sup> Such diversity also generates profit-shifting across jurisdictions<sup>7</sup>, which violates the economic objectives of the Treaty of the Function of the European Union (TFEU).<sup>8</sup> Therefore, corporate tax has received particular attention since the inception of the European Community (EC) and several studies and legislative attempts have been designed to achieve at least some degree of harmonisation of the corporate tax system.<sup>9</sup> These studies include the 1962 Neumark Report<sup>10</sup> and the 1970 Tempel Report.<sup>11</sup> These reports were followed by a number of proposed directives with the aim of partial integration of corporation taxes, including two directives focused on loss compensation in 1984 and 1985, a draft proposal of 1988 for the harmonisation of the tax base, and a proposal suggesting a rate band for corporation tax rates. However, there was never a realistic chance for unanimous support for these proposed directives. In 1990 the Ruding Committee Report did not see the need for corporate tax harmonisation in the Internal Market, though it recommended some measures, such as minimum corporate tax rates and double taxation relief.<sup>12</sup> Nevertheless, some of the European Commission's proposals which had originated earlier were adopted in 1990, such as the Merger Directive,<sup>13</sup> Parent-Subsidiary Directive,<sup>14</sup> and Arbitration Convention.<sup>15</sup>

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<sup>6</sup> For more details on how corporate taxation affects Foreign Direct Investment, see Agnes Benassy-Quere, 'How Does FDI react to corporate taxation?' *International Taxation and Public Finance*, 2005, 12, pp. 583-603.

<sup>7</sup> Gaetan Nicodeme, 'Taxation Papers: Corporate income tax and economic distortions', (European Union 2009) available at

<[http://ec.europa.eu/taxation\\_customs/common/publications/services\\_papers/working\\_papers/index\\_en.htm](http://ec.europa.eu/taxation_customs/common/publications/services_papers/working_papers/index_en.htm)> accessed 20 January 2013; Paulus Merks, 'Corporate Tax and the Global Village', *Intertax*, Vol. 34, No.1, 2006, pp.26-31, at 27.

<sup>8</sup> See Art.2 of the TFEU.

<sup>9</sup> See Taxation and Custom Union at

<[http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/gen\\_overview/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/gen_overview/index_en.htm)> accessed 24 January 2013.

<sup>10</sup> EEC Commission, Fiscal and Financial Committee, Report on Tax Harmonization in the Common Market (Neumark Report) (July 8, 1962), reissued in the EEC Reports on Tax Harmonization: The Report of the Fiscal and Financial Committee and the Reports of the Subgroups A, B, and C, at 93-203 (H. Thurston translation, 1963)

<sup>11</sup> Commission of the European Communities, 'Corporation and Individual Income Tax in the European Communities', Brussels (the Tempel report) 1971.

<sup>12</sup> Commission of the European Communities, 'Report of the Committee of Independent experts on Company Taxation', Vol 19, March 1992, Office for Official publication of the European Communities, Luxembourg 1992.

<sup>13</sup> Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, O J L 225, 20/08/1990 p.1.

<sup>14</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, O J L 225, 20/08/1990 p. 6.

<sup>15</sup> Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, O J L 225, 20.8.1990, p. 10.



### 1.1.1 The reasons for the CCCTB project

In 2001, it was realised that the situation with respect to company taxation in Europe was still the same as it had been at the time of the ‘Ruding Report’, especially with increasingly close European Economic integration, i.e. cross-border activities have substantially increased and the European Monetary Fund (EMU) has been created.<sup>16</sup> However, the Internal Market is incomplete because there are still several tax obstacles to cross-border businesses.<sup>17</sup> In other words, due to the Globalisation process the scope of economic relations has been broadened while the internal organisation of firms operating in international markets has changed as well. Nevertheless, tax systems in the EU have not kept up with these developments, and remain greatly fragmented by reason of multiplicity of tax regimes that often clash.<sup>18</sup>

Currently, profits of multinational enterprises that are derived in some Member States cannot be generally consolidated with losses incurred in other Member States.<sup>19</sup> This often results in over-taxation, when cross-border business activities create tax liabilities that would not have occurred in a purely national context. This also causes double taxation, when the same income is taxed in more than one jurisdiction. In addition, as each Member State is considered as a separate tax jurisdiction and transfers between group members are priced at arm’s length, there is a high cost of complying with transfer pricing formalities and transfer pricing disputes arising within the EU.<sup>20</sup>

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<sup>16</sup> H. Onno Ruding, ‘The Long Way to Remove Obstacles in Company Taxation in Europe’, European Taxation, IBFD January 2002), pp.3-6.

<sup>17</sup> Tax obstacles are defined as

‘cases of distortion where companies face discrimination in their tax treatment in the EU on cross-border activities, including trade, investment and shareholdings, by being subject to double taxation or a higher tax burden within a country than domestic companies for similar transactions of profit’, see *Ibid.* pp.3-6.

<sup>18</sup> Philippe de Buck, ‘How the CCCTB can attract the interest and the support of the Business Community’, World Commerce Review, June 2011, p. 16

<sup>19</sup> European Commission, ‘Tax Treatment in Cross-border Situations’ COM (2006)842 final.

<sup>20</sup> Rosa Perna and Luca Cerioni, ‘The new CCCTB proposed scheme: an opportunity for cross-border business, a challenge for the national Judge’, available at < [http://www.giustizia-amministrativa.it/documentazione/The\\_ccctb\\_proposed\\_scheme-perna\\_cerioni.pdf](http://www.giustizia-amministrativa.it/documentazione/The_ccctb_proposed_scheme-perna_cerioni.pdf)> accessed 7 October 2013.

This setting works as disincentives for investment in the EU and, consequently, goes against the priorities set in Europe 2020 – A strategy for smart, sustainable and inclusive growth.<sup>21</sup> The priority objective is therefore the elimination of tax obstacles to corporate cross-border activity in a single market with a strategy of promoting the effectiveness of the Internal Market.

In a breakthrough study published in 2001, the European Commission<sup>22</sup> highlighted the corporate tax obstacles hindering European-wide activities as being double taxation, double non-taxation, tax abuse, and high compliance cost. These obstacles result the lack of a single taxation system for multinational enterprises and allocating the multinational enterprises' profits at arm's length by transfer price.<sup>23</sup>

In the 2001 study, the Commission outlined four comprehensive solutions, which can help to systemically eliminate tax obstacles, including Home State Taxation (HST)<sup>24</sup> and the Common Consolidated Corporate Tax Base (CCCTB).<sup>25</sup> The Commission decided to promote only the CCCTB initiative and established a working group to make it operational.<sup>26</sup>

Considering the above-mentioned background of the corporate tax harmonisation in the EU, it can be said that the CCCTB proposal can be traced back a number of decades, more specifically it dates back to the inception of the Single Market project of 1985, nonetheless the unanimity requirements on fiscal issues was the reason why it was held back (and it would be the obstacle to implement it in the future). However, due to the full freedom of capital movements which was adopted in 1992, the harmonisation of

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<sup>21</sup> European Commission, 'Europe 2020 – A strategy for smart, sustainable and inclusive Growth' (Communication) COM (2010) 2020.

<sup>22</sup> The essential role of the European Commission is to execute and represent the interests of the entire EU. In this regard, it propose legislation to the European Parliament and the European Council, in connection with this role, it is the only body responsible of drawing up proposals for new European legislations such as Directives. These legislations must defend the interests of the whole Union and its citizens. The Commission has other tasks such as managing and implementing the EU policies and budget, enforcing the EU law and representing the Union on the international stage. See 'European Union Institutions and Bodies' at [http://ec.europa.eu/index\\_en.htm](http://ec.europa.eu/index_en.htm) > accessed 10 February 2013.

<sup>23</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final. p. 223; Ilan Benshalom, 'comprehensive solution for a Targeted Problem: A Critique of the European Union's Home State Taxation Initiative', *European Taxation*, December 2008, pp. 630-641 at 632.

<sup>24</sup> For discussion of HST see generally Sven-Olof Lodin and Malcolm Gammie, *Home State Taxation* (IBFD Amsterdam 2001).

<sup>25</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final. p. 306.

<sup>26</sup> Paulus Merks, 'Corporate Tax and the European Commission', *Intertax*, Vol. 36, 2008, pp.2-13.

taxes turned out to be a priority for EU Member States. The EU institutions, in concert with the European multinationals, were eager to establish a ‘level playing field’ within the Single European Market, especially in fiscal matters.<sup>27</sup> Moreover, the question of corporate tax harmonisation was urged by the creation of the Euro. Since the Euro included members with different economic profiles and levels of economic development, it was deemed necessary to stimulate more convergence through structural reforms including a comprehensive tax reform.<sup>28</sup>

Eventually, on 16 March 2011, the European Commission published a Directive proposal on the CCCTB for the EU-wide activities of multinational enterprises.<sup>29</sup> The CCCTB Directive would allow for EU-multinational groups to opt for common rules on the determination of their taxable profits. In this respect it was discussed whether the common tax base in the EU can be established by using the International Financial Reporting Standards (IFRS) as a starting point for determining the tax base.<sup>30</sup> The CCCTB Directive allows for the cross-border offsetting of profits and losses of the group members in different Member States; that is, the consolidation mechanism and the elimination of intra-group transactions. ‘Consolidated tax base’ is defined as the outcome of adding up the tax bases of all group members after they are calculated under the CCCTB’s common tax rules.<sup>31</sup> It would also lead to the sharing of the consolidated tax base amongst Member States according to an apportionment formula. Nevertheless, the CCCTB as proposed would be applied as an “opt-in” system rather than being mandatory, and each CCCTB-Member State would be left free to set its corporate tax rate according to its national prerogative.<sup>32</sup>

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<sup>27</sup> Victoria Curzon Price, ‘The CCCTB: An instance of the EU’s Icarus Complex?’ available at <<http://www.taxcompetition.org/articles/ccctb>> accessed 5 October 2013.

<sup>28</sup> Victoria Curzon Price, ‘The CCCTB: An instance of the EU’s Icarus Complex?’ available at <<http://www.taxcompetition.org/articles/ccctb>> accessed 5 October 2013.

<sup>29</sup> European Commission, ‘Proposal for a Council Directive on a Common Consolidated Corporate Tax Base’ COM (2011) 121/4. (Hereinafter the CCCTB Council Directive).

<sup>30</sup> Andreas Oestreicher and Christoph Spengel, ‘Tax Harmonisation in Europe: The Determination of Corporate Taxable income in the Member States’, *European Taxation*, October 2007, pp437-451.

<sup>31</sup> Art. 4(11) of the CCCTB Directive.

<sup>32</sup> Arts. 1, 6, 57, 86 of the CCCTB Council Directive.

### 1.1.2 The potential contributions of the CCCTB in the EU context

The main objective of the CCCTB scheme is to facilitate the achievement of the European Treaties policy objectives, such as the establishment of the Internal Market.<sup>33</sup> It would contribute to the Lisbon Strategy in achieving enhanced growth, jobs and competitiveness within the EU.<sup>34</sup>

From a theoretical perspective, the impact of the CCCTB's implementation at the EU level implies that the CCCTB scheme could substantially contribute to the completion of the Internal Market.<sup>35</sup> In implementing the CCCTB scheme through its three steps, i.e. the common rules for tax base calculation, consolidation and formulary apportionment, it is expected that it would remove the most serious corporate tax obstacles. Offsetting profit and losses within the consolidated group members would eliminate many discriminatory situations and double taxation. The restrictions and complexities arising from the co-existence of the classical and exemption approaches to international taxation would be reduced.<sup>36</sup> The CCCTB-Formulary apportionment mechanism is a considerable shift from separate accounting with an arm's length pricing method to a new approach for allocating income across the EU. The key concept underlying the sharing mechanism for the tax base is that companies should pay taxes in proportion to their economic activities in a country, which is measured by sales, capital and labour.<sup>37</sup> This would substantially reduce the compliance costs of companies operating across the Internal Market and resolve existing transfer pricing complexities

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<sup>33</sup> Ulli A. Konrad, 'The Common Consolidated corporate tax base in the European Union', *Bulletin for International Taxation*, May/June 2009, p. 252.

<sup>34</sup> European Commission, 'The contribution of taxation and customs policies to the Lisbon Strategy', COM (2005) 532 final, p.3; European Commission, 'Implementing the Community Lisbon programme: Progress to date and next steps towards Common Consolidated corporate tax base (CCCTB)' COM (2006) 157 final, p.3; see also European Commission, 'Implementing the community Programme for improved growth and employment and the enhanced competitiveness of the EU business' COM (2007) 223 final.

<sup>35</sup> European Commission 'Towards a Single Market Act- for highly competitive social market economy - 50 proposals for improving our work, business and exchanges with one another' (Communication) COM (2010)608; European Commission, 'A common consolidated EU corporate tax base', (non-paper to informal ECOFIN's Council, 7 July 2004) p.1.

<sup>36</sup> See European Commission, COM (2006)157 final, p.3.

<sup>37</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.44.

including the economic *double taxation* that result from the transfer pricing adjustments.<sup>38</sup>

It is expected that the CCCTB system will achieve tax neutrality. By reason of consolidation mechanism which is compatible with the economic reality of a group of affiliated companies, the CCCTB has the potential to ensure tax neutrality with regard to the organisational structures of multinational enterprises. Moreover, tax neutrality would be achieved in respect to different modes of investment financing. The different modes of financing at the corporate level would be treated equally for tax purposes, and consequently incentives to change the financial structure would not arise.<sup>39</sup> Under the consolidation mechanism, cross-border restructuring activities will be neutralised and will not trigger exit taxes as the transferred assets and exchanged shares would be ignored as intra-group transactions.<sup>40</sup>

The CCCTB-Formulary apportionment has the potential to satisfy the requirement of inter-nation equity,<sup>41</sup> and to cope better with the issues of simplicity and enforceability. The factors of the formulary apportionment represent the elements that are deemed to generate the group's income. Thus, those countries in which there is a comparably larger share of the multinational enterprise's income-generating production factors will be attributed a larger share of the consolidated tax base. Therefore formulary apportionment would achieve inter-nation equity.<sup>42</sup>

Some empirical studies show that there is a small difference between the common rules for the determination of taxable income under the CCCTB Directive and the international corporate tax practice in the EU-Member States.<sup>43</sup> This means that a

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<sup>38</sup> Jesper Barenfeld, 'A Common Consolidated Corporate Tax Base in the European union- A beauty or a Beast in the quest for Tax Simplicity', *Bulletin for International Taxation*, July 2007, p.258

<sup>39</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.154.

<sup>40</sup> *Ibid*, p.155.

<sup>41</sup> For definition of 'inter-nation equity' see Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Application to the European Union in S Cnossen, *Taxing Capital Income in the European Union: Issues and Options* (Oxford 2000), p.54.

<sup>42</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.156.

<sup>43</sup> Spengel, Christoph; Ortmann-Babel, Martina; Zinn, Benedikt; Matenaer, Sebastian, 'A common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C) TB' (2012) ZEW Discussion Papers, No. 12-039, <<http://hdl.handle.net/10419/59576>> accessed 10 December 2013.

common tax base as proposed in the Council Directive is adequate for replacing the existing rules for the determination of corporate taxable income governed by domestic tax accounting rules in all of the EU-Member States.<sup>44</sup> However, due to the cross-border loss offset of the CCCTB-Formulary apportionment, the effective tax burden and therefore the domestic tax bases of most EU-Member States would decrease.<sup>45</sup> Other empirical studies suggest that the CCCTB system in the EU would significantly reduce the administrative burden,<sup>46</sup> compliance cost and legal uncertainty that businesses in the EU face in having to comply with up to 27 different domestic systems for determining their taxable profits.<sup>47</sup>

Overall, the CCCTB would contribute to more efficiency, effectiveness, simplicity, tax neutrality and transparency in company tax systems and remove the diversity between domestic systems.<sup>48</sup> Thus it would significantly contribute to achieving the priorities set in 'Europe 2020 – A strategy for smart, sustainable and inclusive growth'.<sup>49</sup>

As regards the reaction of the EU-Member States towards the CCCTB project, not all of the national stances have yet been announced; some EU-Member States have explicitly expressed scepticism,<sup>50</sup> although most of the Member States support the general objective of the CCCTB.<sup>51</sup> In addition, as indicated above, the academic literature

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<sup>44</sup> Spengel, Christoph; Ortmann-Babel, Martina; Zinn, Benedikt; Matenaer, Sebastian, 'A common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C) TB' (2012) ZEW Discussion Papers, No. 12-039, <<http://hdl.handle.net/10419/59576>> accessed 10 December 2013.

<sup>45</sup> Clemens Fuest, Thomas Hemmelgarn, Fred Ramb, 'How would the introduction of an EU-wide Formula Apportionment Affect the Distribution and Size of the Corporate Tax Base? An analysis based on German Multinationals', *International Taxation and Public Finance*, Vol. 14, 2007, pp. 605–626.

<sup>46</sup> Robert Cline, Tom Neubig, Andrew Phillips, Christopher Sanger, Aidan Walsh, 'Ernst&Young Study on the Economic and Budgetary Impact of the Introduction of a Common consolidated Corporate Tax Base in the European Union' (EYGM Limited 2010).

<sup>47</sup> European Commission, 'The impact Assessment accompanying document to the proposal for a Council Directive on a Common consolidated corporate Tax Base, Brussels' SEC (2011)316.

<sup>48</sup> See European Commission, COM (2006)157 final, p.3.

<sup>49</sup> European Commission, 'Europe 2020 – A strategy for smart, sustainable and inclusive growth' (Communication) COM (2010) 2020; European Commission, 'Impact Assessment' SEC (2011)316, p.7.

<sup>50</sup> At the moment Nine Member States are objecting the CCCTB proposal; the UK, Ireland, Sweden, the Netherlands, Poland, Romania, Malta, Slovenia and Bulgaria; Matthew Gilleard, 'CCCTB: the view from Member States' (2011) 22 *International Tax Review* 26. However, the first reactions of the European Parliament and the Danish Presidency proposal seem to be promising, see Matthew Gilleard, 'European Parliament Backs Amended CCCTB' *International Tax Review*, April 2012, p. 1.

<sup>51</sup> Kevin A. Bell, 'EU Member States likely to Adopt Common Corporate Tax Base may Omit Consolidated' available at [http://www.internationaltax.bna.com/itax/display/batch\\_print\\_display.adp?searchid=158650](http://www.internationaltax.bna.com/itax/display/batch_print_display.adp?searchid=158650) > accessed 11 November 2011.

provides relatively convincing assessment regarding the impact of the CCCTB on tax revenue of the European Union Member States.<sup>52</sup>

## **1.2 Research Aims**

The main objective of this analysis is to examine whether the CCCTB system - especially international tax rules dedicated for the allocation of taxing rights to the CCCTB jurisdiction - can effectively operate vis-à-vis third countries. This examination is considered from both short and long-term perspective. In the short-term approach, the thesis examines whether the CCCTB system can be implemented within the EU and thus its objective can be achieved disregarding any conflict with corporate tax practice (both domestic and tax treaty-based practice) in third countries. In the long term, the thesis intends to identify the provisions of current OECD-based tax treaties, concluded between the potential CCCTB Member States and third countries, with which the CCCTB international taxation rules would conflict. Where such conflicts occur, the thesis suggests optimal solutions in order to make the CCCTB system function smoothly in relation to third countries. These solutions are mainly considered from theoretical point of view. However, as this research highlights the reaction of the EU Member States towards the CCCTB proposal, it briefly suggests certain practical solution if the theoretical ones seems not to be achievable.

The thesis mainly argues that the CCCTB system would not effectively operate in relation to third countries without reconsidering certain articles in the CCCTB Directive and renegotiating bilateral tax treaties concluded between the CCCTB-Member States and third countries.

## **1.3 Research Importance and problem**

Generally, whether the CCCTB project in its current coverage will be adopted by all Member States - or by some Member States through 'enhanced cooperation',<sup>53</sup> the European Commission needs to ensure that, in the context of the CCCTB, the Internal

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<sup>52</sup> See Andreas Oestreicher and Reinald Koch, 'The Revenue Consequences of Using a Common Consolidated Corporate Tax Base to Determine Taxable Income in the EU Member States' *FinanzArchiv*, Vol.67,2011,pp. 64-102; Michael Devereux and Simon Loretz, 'The Impact of EU Formulary Apportionment on Corporate Tax Revenues', *Fiscal Studies*, vol. 29(1), 2008, pp. 1-33

<sup>53</sup> Luca Cerioni, 'The Possible Introduction of Common Consolidated Bas Taxation via Enhanced Cooperation: Some Open Issues', *European Taxation*, May 2006, pp.187-196.

Market will effectively operate vis-à-vis the outside world. This is because countries' national economies are now becoming more open and multinational enterprises' activities are not limited to specific boundaries such as the EU, but instead are operating globally.<sup>54</sup> In other words, the CCCTB rules should not constitute an obstacle to international trade and FDI flow between the CCCTB-Member States and the outside world (referred to as 'third countries'). In this respect, the CCCTB would need to avoid putting the EU at a disadvantageous position in worldwide tax competition.<sup>55</sup>

More specifically, the interaction between the CCCTB rules and third country tax systems would result in international double taxation with respect to foreign source income, which is taxed in third countries. Moreover, implementing the CCCTB in the EU could encourage income-shifting to low tax third countries which in turn would lead to the erosion of the tax bases of the CCCTB-Member States. In addition, the CCCTB rules can conflict with current bilateral tax treaties concluded between the EU Member States and third countries which would raise the objection of the latter. If the above issues are not considered in designing the CCCTB system, i.e. the international aspects of the CCCTB do not accommodate the international taxation practice of third countries, the very objectives of the CCCTB system would be undermined.

Like any corporate tax system, the CCCTB as a common tax system will have international tax rules, such as provisions on the tax treatment of non-resident companies' activities, which is carried out within the CCCTB jurisdiction, and rules for taxing resident companies on their income derived from third countries; namely, foreign income. Accordingly, this thesis provides a critical analysis of the interaction between the international aspects of the CCCTB system and corporate tax practice in third countries.

In discussing the international aspects of the CCCTB scheme in relation to third countries, there are three problematic issues to be focused on. Firstly, the territorial scope of the CCCTB system, including companies eligible for the CCCTB and the tax

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<sup>54</sup> Jeffrey Owens, 'Taxation within a Context of Economic Globalisation' Bulletin, IBFD, July 1998, pp.290-297.

<sup>55</sup> Clemens Fuest, 'The European Commission's Proposal for a Common Consolidated Corporate Tax Base', Oxford Review of Economic Policy, vol. 24, No.4, 2008, pp. 720-739.



treatment of income received from third countries by a CCCTB company. Secondly, the protection of the common tax base against tax erosion. Thirdly, the interaction between the CCCTB rules and the current double tax treaties concluded between EU-Member States and third countries. These three problematic issues will be clarified as follows:

With respect to the territorial scope of the CCCTB, according to the CCCTB Directive, all companies which are subject to Member State corporate income tax would be eligible for taxation under the CCCTB, including companies residing in the EU and third countries. Nonetheless, the latter would be eligible to opt for the CCCTB only in respect to their permanent establishments located in the EU. Companies operating under the CCCTB regime would be subject to corporate tax on their worldwide income. The income of EU group affiliates which are ultimately controlled by third-country companies is taxable under the CCCTB, and is subject to consolidation and apportionment. This includes the income of both subsidiaries and permanent establishments located in the EU. This implies that the CCCTB territorial scope is confined within the boundaries of the EU, and the foreign income received by a company which is a member in a group is included in the consolidated tax base. On the basis of the United States' experience in applying 'water's edge consolidation',<sup>56</sup> this thesis justifies the limitation of the consolidation and formulary apportionment to the water's edge of the EU.

However, taxing the worldwide income of the CCCTB's companies can result in international double taxation due to the conflict between taxing rights based on a worldwide taxation concept under the CCCTB and source-based taxing rights in third countries. Moreover, limiting the consolidation and formulary apportionment scope to the water's edge of the EU gives opportunities for income-shifting outside the Internal Market, and therefore the erosion of the common tax base.<sup>57</sup> This is mainly because the traditional separate accounting under the arm's length principle continues to apply for

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<sup>56</sup> Walter Hellerstein and Charles E. McLure, Jr, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States, *International Tax and Public Finance*, Vol. 11 ,2004,pp. 199-220.

<sup>57</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,pp.20-30.

business activities with respect to third countries, which gives profit-shifting opportunities via relationships with affiliates outside the EU.<sup>58</sup>

Therefore, this thesis argues that the CCCTB Directive should strive for common rules with respect to tax treatment of inbound payments (in other words, outbound investments) of EU group companies in third countries and outbound payments of third-country companies in the CCCTB Jurisdiction.<sup>59</sup> It should also adopt common provisions for the elimination of double taxation in relation to third countries. Moreover, to prevent an erosion of the tax base due to strategic tax planning, the CCCTB Directive should introduce common anti-avoidance rules in international situations in conjunction with third countries.

For the tax treatment of cross-border business activities between CCCTB-Member States and third countries, the CCCTB Directive distinguishes between outbound investment (taxation of residents) and inbound investment (taxation of non-residents). As regards outbound investment, such as an EU CCCTB-parent company or EU-resident group entities maintaining a permanent establishment or having a subsidiary in a third country, the income derived by a CCCTB group member from a third country source is taxed and included in the consolidated tax base for later apportionment amongst the corresponding Member States. However, double taxation is unilaterally eliminated by a combination of both exemption and credit methods. On the one hand, specific types of income received from a third country are subject to the exemption method: namely, profit distributions (both portfolio dividends and direct investment), proceeds from a disposal of shares outside the group, and income from a permanent establishment located in a third country.<sup>60</sup> Nonetheless, if these incomes are low-taxed in third countries, they will be taxable under the CCCTB system with double taxation relief by the credit method, i.e. switch-over mechanism. On the other hand, income in the form of interest, royalties and any other form of payments which are taxed in the

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<sup>58</sup> Christoph Spengel and Carsten Wendt, 'A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues und Options' (2007) Oxford University for Business Taxation Working Paper WP 07/17, p.26.

<sup>59</sup> This argument is supported by many scholars, see for example Jack M. Mintz, 'Corporate Tax Harmonization in Europe: It's All about Compliance', *International Taxation and Public Finance*, Vol. 11, 2004, pp. 221-234.

<sup>60</sup> Art. 11 of the CCCTB Directive.

third country are taxable,<sup>61</sup> and a credit for withholding tax paid in the source country is granted by those Member States receiving a share of the foreign income.<sup>62</sup>

With respect to the tax treatment of inbound investment, the income of subsidiaries and permanent establishments located in the EU, which are controlled by third-country companies, is subject to a consolidation and apportionment formula. Regarding the tax treatment of payments of dividends, interest, and royalties by EU group companies to a company resident in a third country, these income types will be subject to existing tax treaties which are concluded between the EU-Member States and third countries; in other words, the CCCTB Directive does not provide for common rules in this respect. This thesis examines in depth the tax treatment of cross-border investment between the EU Member States and third countries, and argues that the CCCTB Directive sufficiently eliminates double taxation with respect to income received from third countries. However, the apportionment of credit, which is given for withholding tax paid in third countries, between the corresponding Member States will raise complexities.

For the purposes of protecting the common tax base against tax erosion,<sup>63</sup> the CCCTB Directive lays down anti-abuses rules including General Anti-Abuse Rules (GAAR) and specific anti-abuse rules. Under the GAAR concept, artificial transactions carried out for the sole purpose of avoiding taxation shall be ignored when calculating the tax base.<sup>64</sup> The CCCTB Directive also contains specific anti-abuse rules, which target certain abusive situations, such as Controlled Foreign Corporation (CFC) and Thin capitalisation rules. In general, the CFC is defined as a non-resident company controlled by a resident, which is established abroad to exploit the lower taxation level therein.<sup>65</sup> Therefore, the CFC rules are aimed at eliminating or limiting the ability of residents of a country to establish companies offshore especially in low-tax countries in order to avoid or defer domestic taxation.<sup>66</sup>

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<sup>61</sup> Art. 76 of the CCCTB Directive.

<sup>62</sup> *Ibid.*

<sup>63</sup> For the definition of tax avoidance and tax planning see Paulus Merks, 'Tax Evasion, Tax Avoidance and Tax Planning', *Intertax*, Vol. 34, Issue 5, 20006, pp.272-281.

<sup>64</sup> Art. 80 of the CCCTB Directive.

<sup>65</sup> Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Canadian Tax Foundation, 1986) p.1 et seq.

<sup>66</sup> Michael Lang, *CFC legislations, Tax Treaties and EC Law* (2004 Kluwer Law International), p.17.

Thin capitalisation rules are established in most countries because of the wide differences in the tax treatment of debt and equity financing methods.<sup>67</sup> In the case of debt finance, companies are generally permitted to deduct interest payments on loans for the purpose of calculation of their taxable profits (i.e. pre-tax). In the case of equity finance, however, companies are not permitted to deduct distributions paid to shareholders from their pre-tax profits; rather, dividends are paid from taxed earnings.<sup>68</sup> This gives an incentive to a parent company to finance its subsidiary through an excessive amount of debt rather funding it with equity capital, which gives rise to thin capitalisation.<sup>69</sup> The main objective of the thin capitalisation rules is to apply the arm's length principle by maintaining a balanced allocation of taxing rights and the capability of preventing tax avoidance and tax abuse.<sup>70</sup>

The introduction of anti-abuse rules in the CCCTB raises several issues. Firstly, it is imperative to examine the need of these rules in the context of the CCCTB. Secondly, the CCCTB Directive does not clearly determine the scopes of the specific anti-abuse rules, i.e. whether they are applicable only in relation to between the CCCTB-Member States and third countries, or also apply between the CCCTB-Member States and non-CCCTB-Member States in the European Union. In the latter case, implementing the specific anti-abuse rules has to be tested against EU law provisions, in particular the free movement of capital and freedom of establishment provisions.<sup>71</sup> Under the CCCTB Directive,<sup>72</sup> there is no explicit reference to the hierarchy of the GAAR and other specific anti-abuse rules. The Directive does not clarify whether the GAAR applies only within the EU or in relation to third countries. Neither is it clear whether the GAAR applies to situations which are not covered by the specific anti-abuse rules, or whether it operates in conjunction with those rules, so that a transaction that is not caught by one

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<sup>67</sup> Otmar Thoemmes, and Katja Nakhai, 'Thin Capitalization Rules and Non-Discrimination Principles. An analysis of thin capitalization rules in light of the non-discrimination principle in the EC Treaty, double tax treaties and friendship treaties' *Intertax*, Vol. 32, No. 3, 2004, pp.126-137 at 137.

<sup>68</sup> Advocate General Geelhoed (2006) in Case C-524/04, *Thin Cap GLO v Commissioners of Inland Revenue* on 29 June [2007] ECR I-02107, para.3.

<sup>69</sup> Nikolaj Vinther and Eric Werlauff, 'The Need for Fresh Thinking about Tax rules on Thin Capitalisation' (2003) *EC Tax Review*, pp.97-106, at 106.

<sup>70</sup> See Council Resolution of 8 June 2010 on coordination of the controlled Foreign Corporation (CFC) and Thin Capitalisation rules within the EU, OJ C 156, 16.6.2010, p. 1–2.

<sup>71</sup> European Commission, 'Co-ordinating Member States' Direct Tax Systems in the Internal Market', COM (2006) 823 final.

<sup>72</sup> See paragraph 20 of the preamble of the CCCTB Directive.

of the specific rules could still be fought by the GAAR. This issue requires examination. Overall, this thesis argues that the anti-abuse rules adopted in the CCCTB Directive would sufficiently protect the common tax base.

The CCCTB common rules invoked for the elimination of international double taxation, which inevitably result from the overlapping of CCCTB tax jurisdiction and third countries' tax jurisdiction, have a unilateral basis. This means that, in non-tax treaty situations, these rules will effectively prevent double taxation. Similarly, anti-abuse rules are applicable unilaterally towards third countries.<sup>73</sup> Additionally, an EU-permanent establishment which is owned by a company that is resident in a third country will be subject to consolidation and formulary apportionment, i.e. the income is attributed to the permanent establishment on the basis of formulary apportionment. On the other hand, the EU-Member States and third countries have already concluded double tax treaties prior to the introduction of the CCCTB to the EU. These tax treaties contain provisions regulating the same issues; namely, the elimination of double taxation, the attribution of profit to a permanent establishment, and anti-abuse provisions. Therefore, the CCCTB rules may conflict with provisions of the double tax treaties, which have been concluded between the CCCTB-Member States and third countries before the initiation of the CCCTB scheme.

Although the CCCTB Directive stipulates that the CCCTB provisions override the tax treaties concluded between EU-Member States,<sup>74</sup> it does not regulate the interaction between the CCCTB provisions which are applicable in relation to third countries, and the existing third countries' tax treaties which have been concluded with the CCCTB-Member States. Therefore, it is crucial to examine the compatibility between the CCCTB rules and third countries' double tax treaties. In examining such compatibility, the OECD Model Convention will be used as the basis, as most of the EU-Member States usually follow the OECD Model in their tax treaties with third countries.<sup>75</sup>

This thesis argues that there will be a potential conflict between the CCCTB rules and third-country double tax treaties mainly because the CCCTB constitutes a single tax

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<sup>73</sup> Arts. 81 and 82 of the CCCTB Directive.

<sup>74</sup> Art.8 of the CCCTB Directive.

<sup>75</sup> European Commission, 'Company Taxation in the Internal Market' COM (2001)582 final, p.250.

system, which would be different from the current domestic tax systems of the Member States and their tax treaty policies towards third countries.<sup>76</sup> A short-term solution for such a conflict could be to provide for a transitional period, in which the CCCTB Member States would be allowed to continue applying their current tax treaties with third countries, even if these treaties contravene the CCCTB rules.<sup>77</sup> However, this approach would undermine the CCCTB objective for all taxpayers to be subject to a common set of rules within the CCCTB jurisdiction, and would be a mere postponement of conflict. Therefore, it is argued that in the long run, it is critical for the CCCTB Member States to eliminate the conflict between the CCCTB rules and third-country tax treaties by renegotiating these tax treaties in respect of corporate taxation provisions. Elimination of such conflict would enable the CCCTB system to operate effectively and efficiently in relation to third countries without violating the main objectives of the CCCTB Directive.

It is also imperative to examine which provisions of OECD-based third country tax treaties are in conflict with the CCCTB rules. Accordingly, this thesis examines the compatibility of the CCCTB rules; namely, the rules on tax treatment of outbound payments (taxation of non-residents) and inbound payments (taxation of residents) with third country double tax treaties. It also examines the compatibility of the CCCTB's CFC rules with third country tax treaties as well as the consistency of the CCCTB's thin capitalisation rules with such treaties. In doing so, where a conflict between the CCCTB rules and these treaties is found, this thesis suggests possible solutions for the elimination of such contradiction.

Moreover, unlike income allocation between the members of the consolidated group, which is based on formulary apportionment, the transactions between the consolidated group and related parties outside the group in third countries will be subject to separate accounting and transfer pricing under the arm's length principle in accordance with the OECD transfer pricing guidelines. Accordingly, it seems crucial for third countries to

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<sup>76</sup> European Commission, 'Tax Treatment of Losses in Cross-Border Situations' COM (2006) 824 final (Communication), p.4.

<sup>77</sup> European Commission, Summary record of the Meeting of CCCTB', Brussels, 2 July 2008 Taxud TF1/DB OP, CCCTB/WP/68/en, para. 9; European Commission, Transaction and Dealing between the Group and Entities outside the Group, Brussels, 1/9/2010, TaxudD1/CCCTB/RD\003\doc\en. para.3.

examine how to coordinate and combine separate accounting and CCCTB-formulary apportionment.

### **1.3.1 Egypt's case study and its relevance to other countries**

After examining the international aspects of the CCCTB towards third countries and its impact on third country tax treaties from a general perspective, the effect of the CCCTB on the corporate tax practice of a specific country will also be examined, with the aim of exemplifying the CCCTB's application towards outside world. It has been argued that certain third countries such as the US should be aware of the CCCTB's potential impact on their businesses.<sup>78</sup> In this thesis, the impact of the CCCTB on corporate tax practice in Egypt is examined. Egypt has been selected for this case study because the reciprocal relationship between Egypt and the EU has a relatively long history, and has now reached an advanced level.<sup>79</sup> Within the frame of the Euro- Mediterranean partnership (EMP), Egypt has concluded an Association Agreement (AA) with the Member States of the European Union. There is an Action Plan between Egypt and the EU with the aim of achieving the objectives and provisions of the Association Agreement.<sup>80</sup> As a result of these accords, the volume of trade and Foreign Direct Investment (FDI) between Egypt and the EU has increased significantly in the last few years. There is also a network of bilateral treaties between Egypt and EU Member States on the elimination of double taxation.

The very close relationship between Egypt and the Member States of the EU –especially in respect of trade, FDI and double tax treaties and the geographical location of Egypt – should make Egypt pay attention to the considerable potential impact of the EU-CCCTB system on its businesses. The CCCTB system may not simplify taxation for Egyptian companies operating in Europe, even though the objective of the CCCTB is to reduce the compliance burden on companies, and it may affect the European FDI flow into Egypt. This is likely to exist due to the interaction between the CCCTB-formulary

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<sup>78</sup> Erin Kelechava, Why the US needs to pay attention to the CCCTB', *International Tax Review*, July 2011, Vol.22, No.6, p.28.

<sup>79</sup> Ricardo Gomez, *Negotiating the Euro-Mediterranean Partnership: Strategic Action in EU Foreign Policy*, (England: Ashgate Publishing Limited 2003), p.53.

<sup>80</sup> Sven Biscop, *Euro-Mediterranean Security: A Search for Partnership*, (England: Ashgate Publishing Limited 2003), p.23.

apportionment and Egypt's transfer pricing rules. The CCCTB rules may also contradict provisions of current Egyptian tax treaties with EU-Member States, such as provisions on the elimination of double taxation, the taxation of business income, the permanent establishment definition, and the taxation of dividends, interest and royalties.

Moreover, the outcome of examining the interaction between the CCCTB system and Egypt's corporate tax practice, as will be discussed in greater details in chapter 6, would be beneficial and relevant to other countries such as developing countries. Firstly, those countries who have a very close relationship in terms of trade, FDI and concluded a significant number of double tax treaties with Member States of the EU should pay attention to the introduction of the European CCCTB system as it provides for an ambitious approach regarding the allocation of multinational enterprises income, that is, shifting from separate accounting under the arm's length principle to formulary apportionment. Secondly, developing countries can learn some lesson from Egypt case study, that is, the switch-over clause included in the CCCTB Directive would conflict with the tax-sparing clause which is usually incorporated in the developing countries tax treaties.

Lastly, according to findings of Egypt case study, it would be concluded that any tax system of a certain country that taxes resident on their worldwide income and taxes non-resident on their source income, would be consistent with international taxation rules of the CCCTB scheme.

#### **1.4 Organisation of the thesis**

This thesis is divided into seven chapters, as follows:

##### ***Chapter 1 - Introduction***

This chapter provides an outline of the argument, and identifies the research question, the research limitations and the organisation of the thesis.

##### ***Chapter 2 - The CCCTB regime within the European Union***

Before examining the international dimension of the CCCTB in relation to third countries, it is necessary to examine the operation of the CCCTB regime within the



European Union. The main purpose of Chapter two, therefore, is to analyse the structural elements of the CCCTB and to highlight the main arguments and debate that influenced the design of the CCCTB as seen in the final proposed Directive. Initially, the chapter gives a historical background regarding corporate tax reform in the EU, starting from the Neumark report in 1962 and leading up to the final proposal of the CCCTB Directive in 2011. The chapter goes on to provide the main objective of the CCCTB system. It then shows how the CCCTB operates within the EU, and in doing so, the implementation of the CCCTB system –which involves three main steps – is analysed. The essential features of the CCCTB system are also addressed in this chapter, including the optionality of the CCCTB, the legal instrument of the CCCTB and companies eligible to opt for the CCCTB and the established criteria for such purpose. Finally, it sheds light on the general attributes of the CCCTB in the EU, which involves the examination of the CCCTB compatibility within the EU, for example in terms of the Subsidiarity principle.

### ***Chapter 3 - The territorial scope of the CCCTB system in relation to third countries***

Chapter 3 identifies the main international aspects of the CCCTB system in relation to third countries, and conceptualises the policy of the CCCTB towards such countries. In doing so, it examines the design of the territorial scope of the CCCTB system vis-à-vis outside world. In other words, it investigates how the CCCTB's contour is drawn. In this context, two main issues are investigated. Firstly, the foreign entities to which the CCCTB system is applicable. Secondly, the foreign income that falls under the scope of the CCCTB. As regards the first issue, the chapter highlights the debate over the implementation of either the 'water's edge' or 'worldwide' consolidation concept for the CCCTB system. The endorsement of water's edge consolidation in the CCCTB over worldwide consolidation is justified based on the US experience in this respect.

As regards the CCCTB scope in relation to foreign income, this chapter shows that the ongoing literature is in favour of source-based taxation in the context of the CCCTB. Thus, an attempt will be made to justify the adoption of worldwide taxation in the CCCTB context. Moreover, the chapter will deal with the transfer pricing issue as a basis for the dealings between the consolidated group and entities resident in the third countries.

#### ***Chapter 4 - Double taxation elimination in the CCCTB context and the protection of the common tax base***

Chapter 3 concludes that the elimination of double taxation with third countries is required, that the common tax base needs to be protected against tax erosion, and that there is also a need to provide common rules regarding the tax treatment of cross-border business activities between CCCTB-Member States and third countries. Consequently, chapter 4 generally examines to what extent the double taxation is eliminated in respect of inbound and outbound investment flow between CCCTB-Member States and third countries. The chapter examines the methods invoked for the double taxation elimination as provided by the CCCTB Directive, including the exemption method and the ordinary credit method.

This chapter also investigates the extent to which the common tax base is effectively protected. This involves analysing anti-abuse rules as adopted by the CCCT Directive, including GAAR, CFC rules and thin capitalisation rules. The application of anti-abuse rules vis-à-vis third countries is justified and evaluated to find out how sufficient these rules are in combating tax avoidance and tax evasion and discouraging income-shifting to tax havens.

#### ***Chapter 5 - The impact of the CCCTB rules on current double tax treaties concluded between the EU-Member States and third countries***

Chapter 4 considered the CCCTB provisions on the elimination of double taxation and the protection of the common tax base being established on a unilateral basis, which would enable the CCCTB system to become a new tax system different from the current tax systems of the Member States. It is concluded that such provisions are effective in eliminating double taxation and protecting the common tax base. However, the relationship between the third countries and Member States is ruled by current bilateral tax treaties. Therefore, the CCCTB is likely to have an impact on the current tax treaties. In this chapter, the potential conflict between CCCTB rules and existing double tax treaties concluded between third countries and EU-Member States is examined and possible solutions for such dispute are suggested. The chapter analyses the possibility of

introducing a short-term solution for the potential conflict, which is for third country tax treaties to override the CCCTB provisions.

The chapter moves on to examine the potential conflict between the CCCTB rules and OECD-based tax treaties in the long term, i.e. when the CCCTB rules prevail over third-country tax treaties. In this respect, three issues are focused on. Firstly, the compatibility of CCCTB rules with OECD-based tax treaties in respect to tax treatment of outbound payments – taxation of non-residents – is investigated. Secondly, this chapter investigates the compatibility of CCCTB rule with respect to tax treatment of inbound payments – taxation of residents – with OECD-based tax treaties. Thirdly, the interaction between the CCCTB's CFC, thin capitalisation rules with the OECD-based tax treaties provisions and the OECD-based tax treaties is examined.

#### ***Chapter 6 - Case study on Egypt - The impact of the CCCTB system on Egypt's corporate tax practice***

In the previous chapters, the question of applying the international aspects of the CCCTB system towards third countries is examined from a general perspective. Chapter 6 examines the impact of the CCCTB provisions on corporate tax practice in Egypt. The chapter demonstrates that EU-Member States and Egypt have a very close relationship, particularly in terms of trade and FDI, and a number of bilateral tax treaties. The key features of the corporate tax system in Egypt are outlined. It is argued that the current Egyptian corporation forms will be eligible to opt for the CCCTB scheme in respect of their permanent establishment located in the EU, the corporate tax rate in Egypt would be influenced by the introduction of the CCCTB in the EU.

The main focus of this chapter is placed on the examination of how Egyptian corporate tax rules (both domestic law and treaty-based rules) accommodate to the CCCTB rules which are applicable in relation to third countries. Accordingly, it examines the interaction between the CCCTB and Egyptian tax rules for companies' residency. The compatibility of the CCCTB provisions in respect of elimination of double taxation with Egyptian tax treaties is also investigated. It also deals with the interaction between the CCCTB rules and Egypt's international corporate tax system in respect to the taxation of passive income as well as the taxation of permanent establishment. Finally, the

interaction between the CCCTB-formulary apportionment and Egyptian transfer pricing is addressed, showing that it is imperative to examine how to co-ordinate and combine formulary apportionment in the CCCTB regime with separate accounting in Egypt's tax system.

### ***Chapter 7 - Concluding remarks and recommendations***

Chapter 7 concludes the analysis, observations and findings of the thesis, suggesting amendment for certain provision of the CCCTB Directive. It also suggests solutions where a dispute occurs between the CCCTB rules and third country double tax treaties. The chapter concludes the thesis findings as regards the impact of the CCCTB system on corporate tax practice in Egypt, with some recommendations in respect to the amendment of some of Egypt's tax treaty provisions.

#### **1.5 The research limitations**

The scope of this thesis is confined to the examination of the CCCTB Directive provisions that have an international dimension especially towards third countries, including provisions on the design of the CCCTB territorial scope, provisions on the tax treatment of inbound and outbound investments, and provisions on the elimination of double taxation and tax avoidance. However, for the research purposes this thesis does not examine the coordination between the CCCTB-formulary apportionment and the separate accounting under the arm's length principle outside the water's edge of the EU. Moreover, neither the CCCTB rules for the computation of the tax base nor the administrative aspects of the CCCTB (both within the EU and in relation to third countries) are examined in this thesis.

#### **1.6 The research question**

In order to achieve the objective of the Lisbon strategy and thus for the EU to become the most competitive economy in the world, a Directive proposal on the concept of the CCCTB was published recently. It is clear, at least according to the current academic literature, that the regime of the CCCTB would substantially contribute to the removal of the corporate tax obstacles which hinder the cross-border activities within the EU and thereby the completion of the internal market. However, the international dimension of the CCCTB in relation to third countries still remained to be examined. This research

therefore focuses on the relationship between international taxation rules of the European CCCTB scheme and third countries .i.e. *how do the international aspects of the CCCTB system interact with third countries' tax practice from both a domestic and tax treaty perspective?* In this respect, the territorial scope of the CCCTB has to be examined; that is, to what extent can third-country entities and foreign income be included in the CCCTB; how should double taxation be avoided in relation to cross-border business activities between CCCTB-Member States and third countries, which measures should be taken to protect the consolidated tax base against tax avoidance; and whether there would be a conflict between the CCCTB provisions and current tax treaties concluded between EU-Member States and third countries.

### **1.7 The research hypothesis**

The international taxation rules of the CCCTB system are likely to be different from conventional single Member State rules, i.e. the CCCTB system would constitute a new foreign tax base for third countries. This can impact the corporate tax practice in third countries. In this respect, the common tax base would be exposed to tax abuse from non-EU countries. Moreover, the CCCTB system includes common provisions regarding the elimination of double taxation and tax avoidance in relation to third countries. These provisions seem to be different from the current practice of the individual Member States, thus they are likely to conflict with the relevant provisions included in the existing tax treaties between third countries and EU-Member States. The conflict between the CCCTB and OECD Model bilateral treaties is detrimental to the effective functioning of the CCCTB system vis-à-vis third countries, and need to be redressed. This thesis suggests a simple and practical solution - replacement of the bilateral tax treaties between CCCTB-Member States and third countries with a multilateral tax treaty to be concluded between every third country and all CCCTB-Member States.

### **1.8 Methodology and Material**

This research is conducted from a doctrinal legal perspective which involves a systematic analysis of a statement of law encapsulated in statutory provisions governing a particular legal category; an entrenched legal principles involved therein and relevant

judicial pronouncements thereon.<sup>81</sup> The aim of the doctrinal legal research is to logically and rationally analyse the relationship between rules, i.e. consistency and certainty of the law, explain the area of difficulty, and also to initiate further development of legal principles and doctrines,<sup>82</sup> i.e. infer some legal propositions.<sup>83</sup>

Correspondingly, this thesis attempts to analyse certain substantive statutory provisions, that is, the provisions contained in the CCCTB Directive on the allocation of taxing rights to the potential CCCTB jurisdiction, in particular the provisions dedicated for determining the territorial scope of the CCCTB, elimination of international double taxation, and the protection of the consolidated tax base, i.e. anti-abuse rules. The objective of this analysis is to examine the consistency of such provisions with EU law and third country international corporate tax practice. In doing so, the relevant provisions incorporated in the OECD Model Tax Convention are invoked as a benchmark. Moreover, For the purpose of investigating the compatibility of the CCCTB international aspects with EU law, particularly the free movement of capital and freedom of establishment provisions, relevant ECJ decisions are emphasised. Furthermore, this research justifies legal tax principles involved such as water's edge consolidation and worldwide taxation concepts which are endorsed by the CCCTB Directive. Therefore, it can be said that, the doctrinal research approach is adequate to achieving the aims of this thesis.

The main advantages of doctrinal legal research as described above, i.e. the analytical doctrinal methodology are that it provides solutions to the problem usually with very limited time, as the legislation and case-law are subject to a continuous expounding and analysis and the statutory provisions and judicial pronouncements are integrated into a coherent and workable body of doctrine. In contrary, Empirical research takes much

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<sup>81</sup> Terry Hutchinson, *Researching and Writing in Law* (Reuters Thomson, 3<sup>rd</sup> ed, 2010), p.37.

<sup>82</sup> 'Doctrine' is defined as:

[a] synthesis of various rules, principles, norms, interpretive guidelines and values. It explains, makes coherent or justifies a segment of the law as part of a larger system of law. Doctrines can be more or less abstract, binding or non-binding',

see Trischa Mann and Audrey Blunden(eds.) *Australian Law Dictionary* (Oxford University Press, 2010),p. 197

<sup>83</sup> Ian Dobinson and Francis Johns , ' Qualitative Legal Research' in Wing Hong Chui(ed.) *Research Methods for Law*(Edinburgh University Press, 2007),p.19.

more time to reach conclusions.<sup>84</sup> In addition, doctrinal analysis helps in identifying the legislative gaps, ambiguities or inconsistencies in the substantive law provisions concerned. Subsequently, the Legislature is invited to fill such gaps, for instance through amendments, or to substitute the ambiguous provisions by another piece of legislation, so that the law can be more purposive and effective. This legislative movement which leads to the replacement or to the amendment of the law, results in the enhancement of the law.<sup>85</sup>

Therefore, following a doctrinal analysis in this thesis (focusing on the interaction between the international aspects of the CCCTB and third countries) would help in identifying potential conflict that arises between the CCCTB rules, which apply in an international context, and existing OECD-based tax treaties concluded between CCCTB-Member States and third countries. Consequently, where such conflict occurs solutions will be suggested. This would invite the European Commission to reconsider the CCCTB Directive provisions that contradict the relevant provisions incorporated in the third countries tax treaties or consider renegotiating such tax treaties. This in turn would make the European CCCTB system function effectively in relation to third countries.

On the other hand, considering the aim of empirical research methodology,<sup>86</sup> that is, investigating through empirical data how law and legal institutions affect human attitudes and what impact on society they have. It can be said therefore that empirical methodology is not appropriate to achieving the thesis aims as this research does not seek to examine the impact of the CCCTB system on tax revenue of a group of companies or on their compliance cost, i.e. it does not investigate the economic implications of the CCCTB on multinationals or their reaction to such system. It merely

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<sup>84</sup> Kenneth Culp Davis, 'Behavioral Science and Administrative Law' 17 J. Legal Educ. 152 (1964-1965), p.151.

<sup>85</sup> Terry Hutchinson, 'Doctrinal research: researching the Jury' in Dawn Watkins, Mandy Burton (eds.) *Research Methods in Law* (Routledge 2013), p.10 and 23.

<sup>86</sup> Empirical methodologies is defined as:

'Fundamental research — 'Research designed to secure a deeper understanding of law as a social phenomenon, including research on the historical, philosophical, linguistic, economic, social or political implications of law',

see Consultative Group on Research and Education in Law, *Law and Learning: Report to the Social Sciences and the Humanities Research Council of Canada* (Information Division of the Social Sciences and Humanities Research Council of Canada, 1983) cited in Terry Hutchinson and Nigel Duncan, 'defining and describing what we do: Doctrinal Legal Research', *Deakin Law Review*, Vol.17, No.1, 2012, p.102.

analyses certain rules of the CCCTB Directive in order to examine its compatibility with the relevant provisions of third countries corporate tax system. Moreover, knowing that the CCCTB Directive is not yet implemented, empirical research would be more inconvenient and an accurate conclusion cannot be drawn<sup>87</sup> as most of the CCCTB effects such as its influence on the Member State tax revenues will depend on the national tax policy of each Member State with respect to the available adaptation of the different tax instruments or the prevailing tax rates.<sup>88</sup> Thus, doctrinal analysis mythology is more appropriate than empirical research methodologies in terms of achieving the aims of the thesis.

The analysis in this thesis is based on both primary and secondary sources and is the outcome of a library-based research. The primary sources of this thesis include the statutory legislation, regulations, double tax treaty models such the OECD Model, and case law, especially those of the European Court of Justice (ECJ). The CCCTB Directive proposal that issued by the European Commission constitutes the main source. The secondary sources consist of various references such as books, journals, websites and databases such as West Law. The publications of the European Commission and the Working Documents produced by the Working Group employed by the European Commission to analyse and suggest the provisions of the CCCTB Directive, are a key source for this thesis. The information is sourced through libraries in the United Kingdom and Egypt.

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<sup>87</sup> For drawbacks of empirical research methodology see Kylie Burns and Terry Hutchinson, 'The Impact of 'Empirical Facts' on Legal Scholarship and Legal Research Training' available at <[http://www98.griffith.edu.au/dspace/bitstream/10072/28586/1/56796\\_1.pdf](http://www98.griffith.edu.au/dspace/bitstream/10072/28586/1/56796_1.pdf)> accessed 12 October 2013.

<sup>88</sup> European Commission, 'Impact Assessment' SEC (2011)316, p.5.



## 2 The Common Consolidated Corporate Tax Base project in the European Union

### 2.1 Introduction

Corporate taxation in the EU reveals a wide diversity,<sup>89</sup> and this creates numerous obstacles with respect to cross-border businesses within the EU.<sup>90</sup> These tax obstacles distort investment decisions with regard to the investment location and type and the finance source for the investment.<sup>91</sup> This in turn distorts the efficient allocation of resources within the EU.<sup>92</sup> Multinational enterprises operating across the EU currently have to comply with the 27 different separate tax systems of Member States, which entails a considerable compliance cost, and this in turn hinders cross-border activities within the EU. Currently, each Member State is regarded as a separate tax jurisdiction, thus multinational enterprises are not subject to a single tax system; for instance, in most cases there is no loss offsetting between associated enterprises located in different Member States. This leads to double taxation as a result of conflicting taxing rights. Additionally, the apportionment of profits of multinationals to different jurisdictions on an arm's length basis by transfer-pricing creates practical complexities and causes double taxation. Therefore, corporate tax reform in the EU is essential.<sup>93</sup> In order to reduce or even remove these tax obstacles, the European Commission in 2001 suggested introducing a Common Consolidated Corporate Tax Base (CCCTB) for the EU-wide businesses of multinationals. However, the CCCTB project was not the first initiative; it was preceded by several legislative attempts and studies with the purpose of corporate

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<sup>89</sup> See generally Dieter Endres et al, *The Determination of Corporate Taxable Income in the EU Member States* (Kluwer Law International 2007).

<sup>90</sup> Ben and Terra, *European Tax Law* (Kluwer law International 2008), p.239.

<sup>91</sup> For more on how corporate taxation affect Foreign Direct Investment see Agnes B.Q, 'How Does FDI react to Corporate Taxation', *International Taxation and Public Finance*, 12, 2005, 583-603; Julian Al worth, 'The Effect of Taxes on Corporate Financing Decisions: Evidence from a Panel of Italian Firms', *International Taxation and Public finance*, Vol.8,2001, 8, pp.353-376.

<sup>92</sup> Gaetan Nicodeme, 'Taxation Papers: Corporate income tax and economic distortions', (European Union 2009) available at <[http://ec.europa.eu/taxation\\_customs/common/publications/services\\_papers/working\\_papers/index\\_en.htm](http://ec.europa.eu/taxation_customs/common/publications/services_papers/working_papers/index_en.htm)> accessed 20 January 2013.

<sup>93</sup> See Sijbren Cnossen, 'Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda', *Bulletin for International Fiscal Documentation*, April 2004, pp.134-150.

tax harmonisation in the EU. These included, for instance, the Neumark Report 1962 and The Ruding Committee Report 1992.

On 16 March 2011, the European Commission released a Draft Council Directive on the CCCTB.<sup>94</sup> The implementation of the CCCTB scheme involves three steps. Firstly, the corporate taxable income of each group member is determined separately under a common set of tax accounting rules. Secondly, the individual corporate tax bases of a group of companies are consolidated into a common tax base. Thirdly, the consolidated tax base is shared between the group's members located in the different Member States by formula apportionment.

To this end, this chapter provides a historical background on company tax reform in the EU as well as the objective of the CCCTB project. The main features of the CCCTB are analysed, and the main purpose of this chapter is to demonstrate the implementation process of the CCCTB system in the EU. In doing so, the debate which influenced the design of the CCCTB provisions is highlighted. In this respect, an endeavour is made to justify the design of the CCCTB as in the final proposed Directive. This is a prerequisite for understanding the international aspects of the CCCTB, which will be dealt with in the next chapters. This chapter highlights the possibility of importing the elements of IFRS, which meets the requirements of a CCCTB, into the common base. This chapter argues that the CCCTB would significantly reduce the compliance costs of companies operating across the Internal Market, resolve existing transfer-pricing problems, avoid various situations of double taxation and remove many discriminatory situations and restrictions.<sup>95</sup> It also argues that the harmonisation of corporate tax rates in the EU cannot be an alternative to the CCCTB.

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<sup>94</sup> The Draft Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) is available at <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/com\\_2011\\_121\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf)> accessed 10 January 2013.

<sup>95</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final, pp.370-399.

## 2.2 Historical background of company tax reform in the European Union

The debate over EU corporate tax harmonisation is not new; it dates back at least fifty years, and has taken a number of forms.<sup>96</sup> This brief historical outline will examine a number of features of the debate.

The establishment of the Common Market, which was a key objective of the original EEC Treaty,<sup>97</sup> involved the removal of obstacles in respect to corporate taxation.<sup>98</sup> This was examined in 1960 by the Neumark Committee, which reported its findings in 1962.<sup>99</sup>

The Neumark Committee was concerned with the examination of the impact of tax diversity on the establishment of a common market in the EEC. The Neumark Report revealed the seriousness of each tax obstacle in the EEC and the possible solution for removing such obstacles. In respect to corporate taxation, the Report recommended a degree of approximation of domestic tax systems with respect to provision on tax base calculation. The Neumark report also suggested the harmonisation of the corporate tax system in the EEC in the form of an imputation system with a split tax rate in the six founding Member States of the EC, proposing a flat rate of around 50% on retained profits and a rate of between 15% and 25% on distributed profits.<sup>100</sup> The harmonisation of corporate tax systems is seen as a necessary step for concluding a multilateral tax treaty between Member States.<sup>101</sup>

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<sup>96</sup> Peter Birch Sorensen, 'Company tax Reform in the European Union', *International Taxation and Public Finance*, Vol.11, 2004, pp. 91–115; Michael P.Deverux, 'Debating Proposed Reforms of the Taxation of Corporate Income in the European Union', *International Taxation and Public Finance*, Vol.11,2004,pp.71-89 at 71.

<sup>97</sup> Art.2 of Treaty establishing the European Economic Communities, signed at Rome in 1957.

<sup>98</sup> Alex Easson, 'Harmonisation of Direct Taxation in the European Community: from Neumark to Ruding', *Canadian Tax Journal*, Vol.40, 1992, pp. 600-638, at 601.

<sup>99</sup> EEC Commission, Fiscal and Financial Committee, Report on Tax Harmonization in the Common Market (Neumark Report) (July 8, 1962), reissued in the EEC Reports on Tax Harmonization: The Report of the Fiscal and Financial Committee and the Reports of the Subgroups A, B, and C, at 93-203 (H. Thurston translation, 1963)

<sup>100</sup> *Ibid.*

<sup>101</sup> Michel Aujean, 'The CCCTB Project and the Future of the European taxation' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008)p.15.

Following the Neumark Report, the Segre Committee's Report was issued in 1966.<sup>102</sup> It was primarily concerned with the establishment of an integrated capital market within the Community. The Segre Committee concluded that the creation and the proper function of the European Capital Market required tax neutrality; in other words, tax considerations should not affect the choice of the investment location, nor it should impact on the investor's choice between direct investment and intermediary investment. The Committee identified the key tax obstacles as international double taxation of investment income and tax discrimination against foreign investors. Accordingly, the Segre Report suggested some corrective measures including the adoption of a multilateral tax convention, the abolition of withholding tax on interest payments or the adoption of a common rate of withholding tax, and the harmonisation of taxes on capital. It also recommended the application of tax credits in respect of tax paid by companies to non-resident shareholders.<sup>103</sup> In 1969, directives were proposed on parent-subsidiaries<sup>104</sup> and mergers.<sup>105</sup>

Due to the disagreement on the above recommendations, which would not eliminate double taxation, the European Commission asked A.J. van den Tempel to deliver a report by end of the 1960s.<sup>106</sup> The Van den Tempel Report in 1970 suggested a classical corporate system within the Community instead of the imputation and split-rate systems which were used at that time. However, the Commission opted later for the imputation system on the grounds that most of the Member States favoured it.<sup>107</sup>

In 1975, the Commission realized that no agreement was to be reached by refraining from any form of double taxation relief. Thus, it altered its strategy and tabled a proposal for a directive on the harmonization of company and dividend taxation, calling

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<sup>102</sup> Commission of the European Communities, 'The Development of a European Capital Market' (Report of a Group of experts appointed by the EEC Commission), Brussels 1966.

<sup>103</sup> Alex Easson, 'Harmonisation of Direct Taxation in the European Community: from Neumark to Ruding', *Canadian Tax Journal*, Vol.40, 1992, pp. 600-638, at 604.

<sup>104</sup> Draft Directive on the Common System of Taxation Applicable in the Case of Parent and Subsidiaries of Different Member States, COM (69) 6 final.

<sup>105</sup> Draft Directive on the Common System of Taxation Applicable in the Case of Mergers, Divisions and Contributions of Assets Taking Place between Corporations of Different Member States. COM (69) 5 final.

<sup>106</sup> Commission of the European Communities, 'Corporation and Individual Income Tax in the European Communities', Brussels (the Tempel report) 1970.

<sup>107</sup> Michael P.Deverux, 'Debating Proposed Reforms of the Taxation of Corporate Income in the European Union', *International Taxation and Public Finance*, Vol.11, 2004, pp.71-89 at 71.

for partial integration of the corporation tax.<sup>108</sup> The aim of this proposal was to eliminate economic double taxation under the concept of a centralised tax harmonisation system. The Commission proposed a partial imputation system and a common withholding tax of 25% with a statutory rate within a range of 45%-55%, and a tax credit within a band of 45 to 55% for dividend recipients irrespective of their residency. At the same time, it was also proposed that all Member States should impose a 25% withholding tax on dividends distributed by their resident companies.<sup>109</sup>

This proposed directive was disapproved because harmonising corporation tax systems and statutory tax rates would not be effective as long as the rules on the tax base calculation remained different amongst Member States.<sup>110</sup> Furthermore, the European Parliament reported that the tax base should be harmonised. The proposal was withdrawn in 1990 as the concept of economic integration was defined and developed under the principle of Subsidiarity and the preoccupation was to approximate and coordinate member states' tax systems rather than establish fixed harmonisation at the European level.<sup>111</sup>

In 1984, the Commission proposed to harmonise the rules for the carry-over of losses. This proposal was discussed by the Council in 1985 and then withdrawn.<sup>112</sup> In 1988, the Commission attempted to begin the harmonisation of the corporate tax base by drafting a proposal on common rules for the calculation of business profits.<sup>113</sup> At that time, this proposal was seen as a prerequisite to achieve tax transparency, certainty and optimal allocation of resources, which in turn would be a critical step towards the establishment

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<sup>108</sup> Draft Directive on the Harmonization of Systems of Company Taxation and of Withholding Tax on Dividends, COM (75) 392 final.

<sup>109</sup> Commission, 23 July 1975(Communication to the Council) Doc. COM (75)391.

<sup>110</sup> See European Parliament's Resolution of November 17, 1983, OJ 1983 C342/73; Ben Patterson (ed.) 'Tax Co-ordination in the European Union' (2000) European Parliament Working Paper ECON 125 EN 2000, p.4.

<sup>111</sup> *Ibid.*

<sup>112</sup> Proposal of Council Directive of 9 September 1982 on the Harmonisation of the Laws of Member States concerning tax Arrangements for the carry-Over of losses on Undertakings' COM(84)404 final OJ1984 C253//5.

<sup>113</sup> John Goldsworth, 'European Commission Proposal for a Directive on common rules for tax base Tax Planning International Review, Vol. 1988, pp.1-12. Coted in Alex Easson, 'Harmonisation of Direct Taxation in the European Community: from Neumark to Ruding', Canadian Tax Journal, Vol.40, 1992, pp. 600-638, at 610.

of the Internal Market. However, this proposal was never discussed, due to the political reluctance of the Member States.<sup>114</sup>

Notably, the above initiatives, especially in the period between 1962 and 1984 were not successful, for different reasons.<sup>115</sup> The main reason was the lack of required unanimity: the accession of new Member States in 1973 complicated the decision-making process. In addition, the debate over the community budget and economic recession dominated the scene, especially in the early 1980s. Moreover, the above proposals were not supported by the business community and academia because they were not economically justified and had no clear strategic vision.<sup>116</sup> However, this period of time saw a little progress in the field of company taxation, such as the adoption of a directive on companies' capital duties, which was aimed at reducing the obstacles to the establishment of companies and the cross-border movement of capital.<sup>117</sup>

Being aware of the noticeable lack of success in the above initiatives, the Commission adopted a new strategy whereby the direct tax measures should aim at the completion of the Internal Market and be compatible with the concept of subsidiarity, and all proposals should be designed through consultation with the Member States.<sup>118</sup>

Consequently, the Commission proposed three measures concerning the harmonisation of substantive provisions of national corporate taxation; namely, two directives and one convention. In 1990, the Merger Directive and The Parent-Subsidiary were adopted. The Merger Directive<sup>119</sup> is designed to defer taxation of capital gains resulting from certain categories of business re-organisation such as mergers, divisions, transfers of assets and exchanges of shares concerning companies from different Member States. It seeks to create within the Community conditions analogous to those of an internal

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<sup>114</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final. p. 16.

<sup>115</sup> For more historical information on this era see Eason Alexander James, *Tax law and policy in the EEC* (London: Sweet & Maxwell, 1980), p.157et seq.

<sup>116</sup> Michel Aujean, 'The CCCTB project and the Future of the European taxation' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.16.

<sup>117</sup> Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital, OJ No L 249, 3. 10. 1969, p. 25.

<sup>118</sup> Commission of the European Communities, 'Guidelines on Company Taxation' (Communication) SEC (90)601 final, p.2.

<sup>119</sup> Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation applicable to Mergers, Divisions, transfers of assets and exchanges of shares concerning companies of different Member States, O J L 225 , 20/08/1990 ,p.1.

market and thus to ensure the establishment and effective functioning of the common market. The Parent-Subsidiary Directive<sup>120</sup> mainly aims at the elimination of double taxation on distributed profits between a subsidiary and a parent company of another Member State. Both directives were ratified in 1992. Moreover, the Arbitration Convention<sup>121</sup> was adopted in 1990 and ratified in 1995. It principally aimed to establish a process for resolving transfer-pricing disputes that gives rise to double taxation.<sup>122</sup>

The European Commission<sup>123</sup> also published a draft Directive on the abolition of withholding taxes on interest and royalty payments between parent companies and subsidiaries,<sup>124</sup> and another one on the set-off of losses sustained by branches and subsidiaries.<sup>125</sup> However, this proposal was withdrawn later in 2001,<sup>126</sup> due to the reluctance of the Member States and Council to adopt these initiatives.<sup>127</sup>

In a communication from the Commission to the European Parliament and the Council in 1990<sup>128</sup>, it was indicated that company taxation causes economic distortion because of its effects on the location decisions of investment and its non-neutrality both at the domestic and international level. Thus, the Commission gave the Committee of Independent Experts on Company Taxation, under the Chair of Mr Onno Ruding, a precise mandate for the analysis of company tax issues in the European Community.<sup>129</sup>

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<sup>120</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, O J L 225 , 20/08/1990 ,p.6.

<sup>121</sup> Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises of Different Member States, 90/436/EEC, OJ L 225, 20.8.1990, p.10.

<sup>122</sup> For more useful review see Otmar Thommes, 'The European Dimension in International Law', Intertax, Vol.10, 1990, pp.464-476.

<sup>123</sup> Ben Patterson (ed.) 'Tax Co-ordination in the European Union' (2000) European Parliament Working Paper ECON 125 EN 2000, p.4.

<sup>124</sup> European Commission, 'Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States' COM (90) 571 final 1991. (Withdrawn in 1994).

<sup>125</sup> Proposal for a Council Directive on Arrangement for taking into account by enterprises for losses of their Permanent Establishment and Subsidiaries situated in other Member States COM(90) 595 final, OJ1991C 595.

<sup>126</sup> European Commission, 'Towards an Internal Market without Tax Obstacles' (Communication) COM (2001) 582 final, p.6.

<sup>127</sup> Commission, 'An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges' (Communication) COM (2003)726 final, p.9.

<sup>128</sup> Commission of the European Communities, 'Guidelines on Company Taxation' (Communication) SEC (90)601 final, p.2.

<sup>129</sup> European Commission, 'Report of the Committee of Independent Experts on Company Taxation' (Ruding Committee), Luxemburg 1992.

### 2.2.1 The Ruding Committee Report

The Ruding committee was asked to answer the following questions: Whether multifariousness in taxation within the Member States distorts the function of the Internal Market, especially in respect to investment decisions and competition; and, insofar as such distortions occurs, are they likely to be removed solely via the interaction of market forces and tax competition between domestic tax systems, or is action at Community level needed? In the event that Community action is required, what specific procedures should be invoked to prevent or alleviate these distortions?<sup>130</sup>

In March 1992 the Ruding Committee published a report revealing that there are a wide diversity in company taxation in the Community, including the rules on the computation of the tax base and statutory corporate tax rates.<sup>131</sup> More specifically, cross-border payments such as dividends, interest and royalties were treated differently. Moreover, the Ruding committee found convergence among Member States in respect to methods of providing relief for double taxation on cross-border income flows. The Committee Report highlighted the problems which are related to the imputation system. It concluded that the cost of capital differed among Member States, causing discrimination against both outbound and inbound investment. The reports concluded that these differences in corporate tax affected the location of the investments and distorted competition, and that Community action is necessary as the distortion could not be eliminated by the interplay of market forces or through a Member State's independent action.<sup>132</sup>

In its recommendations, the Committee Report suggested several individual corrective measures, rather than a comprehensive solution for the harmonisation of corporate tax in the Community. These measures mainly include the prohibition of discriminatory or restrictive practices by Member States' arrangements that hinder cross-border business

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<sup>130</sup> Commission, 'Subsequent to the Conclusions of the Ruding Committee indicating Guidelines on Company Taxation Linked to the further Development of the Internal Market' (Communication) SEC(92) 1118 final,p.2.

<sup>131</sup> European Commission, 'Report of the Committee of Independent Experts on Company Taxation' (Ruding Committee), Luxemburg 1992. For comments on Ruding Report see Malcolm Gammie, *The Ruding Committee report: An initial response*(London: Institute for Fiscal Studies 1992)

<sup>132</sup> European Commission, 'Report of the Committee of Independent Experts on Company Taxation' (Ruding Committee), Luxemburg 1992, chapter 7 and 8.



investment and shareholding. It also recommended that Member States should positively apply a minimum tax rate and common rules for a minimum tax base to stop the erosion of the tax bases in the Community. Maximising transparency in respect to tax incentives granted by Member States to promote investment was recommended.<sup>133</sup>

The Committee went on to provide detailed recommendations. For instance, in order to prevent withholding taxes being imposed by source countries on dividends paid by subsidiaries to parent companies, it was recommended that the scope of the parent-subsidiary Directive should be expanded to encompass all companies subject to corporate income tax, regardless of their legal form. The Committee recommended that tax evasion should be eliminated by applying a uniform withholding tax of 30% on dividend distributions by resident European companies. For the elimination of double taxation which resulted in imposing the source countries' tax on payments between enterprises in different Member States, the Committee recommended the adoption of the proposed interest and royalties Directive. To eliminate double taxation arising from transfer-pricing disputes, the Committee recommended the ratification of the Arbitration Convention.<sup>134</sup>

In order to decrease distortions to cross-border investments, the Committee recommended that the Member States should adopt the proposed directive dealing with losses of permanent establishments and subsidiaries in other Member States. According to this proposal, the Member States should provide for full vertical and horizontal offsetting of losses within groups of enterprises at the national level.<sup>135</sup>

To ensure the elimination of double taxation through bilateral tax treaties, the Committee urged Member States to conclude bilateral income tax treaties where none existed between them, and to complete those where coverage was limited. It also recommended a design of a common policy on double taxation treaties within the Community and in relation to third countries. The Committee urged the Commission in concert with Member States to examine alternative approaches to determine the most

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<sup>133</sup> European Commission, 'Report of the Committee of Independent Experts on Company Taxation' (Ruding Committee), Luxembourg 1992, Chapter 10.

<sup>134</sup> See generally European Commission, 'Report of the Committee of Independent Experts on Company Taxation' (Ruding Committee), Luxembourg 1992.

<sup>135</sup> *Ibid.*

suitable common corporation tax system for the Community in order to achieve a complete corporate tax harmonisation within the Community.<sup>136</sup>

In its response to the Committee report, the Commission confirmed the need to eliminate double taxation on cross-border income flows. However, it said that several recommendations go beyond what was necessary at Community level. The Commission expected that the proposed measures would decrease the tax base, which in turn would lead to an increase in tax rates.<sup>137</sup>

There was no unanimous agreement on the Ruding Report recommendations as they did not offer significant changes from what had been done over the previous prolonged attempts. In addition, it had too many recommendations, most of which were already represented in the Commission's plans, and thus it was not implemented.

### **2.2.2 The 'Tax Package'**

Considering the limited success of the above initiatives, the EU sought a comprehensive approach in respect to tax policy. At that time the notion of tax coordination appeared in addition to tax harmonisation. Subsequently, in 1996, the Commission suggested a new and a comprehensive approach on tax policy.<sup>138</sup> This resulted in the adoption of the 'Monti tax package' of 1997.<sup>139</sup> This was a critical EU initiative in the area of direct taxation for the elimination of harmful tax competition within the EU. The Commission was convinced that protection of the national tax bases from tax erosion would require preventing harmful forms of tax competition. Furthermore, the tax package aimed at reforming the taxation system by reducing the tax burden on labour, and restoring tax-

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<sup>136</sup> For analysis of the detailed recommendation of the Committee Report and their implementation phases see Alex Easson, 'Harmonisation of Direct Taxation in the European Community: from Neumark to Ruding', *Canadian Tax Journal*, Vol.40, 1992, pp. 600-638, at 627.

<sup>137</sup> Commission, 'subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the internal market' (Communication) SEC (92) 1118 final, p.10; for the reaction of the European Council to the Ruding report see Council of the European Communities, 'Guidelines on Company Taxation linked to the Further Development of the Internal Market' press release (10088/92 – Press 216) Council meeting of 23 November 1992.

<sup>138</sup> See Philippe Cattoir, 'A History of the "Tax Package" the Principles and Issues underlying the Community approach (2006) European Commission Working Paper No 10.

<sup>139</sup> European Commission, 'Towards tax Co-ordination in the European Union: A Package to tackle Harmful tax Competition, (Communication) COM (97)495 final.

raising capacities which were threatened by harmful tax measures.<sup>140</sup> The Tax Package included the Savings Directive,<sup>141</sup> the Interest and Royalties Directive,<sup>142</sup> and the Code of Conduct which was the core of the proposal and took a form of political agreement instead of a legally binding instrument. According to the Code of Conduct, the Member States agreed to respect the principles of fair competition and to stop harmful tax measures. It covered laws or regulations, and practice measures.

The implementation of the Code of Conduct is considered to be an effective measure against harmful tax competition. Nonetheless, it led to a controversial debate on the relative positions of different Member States in terms of tax competition, and the impact of the effective tax rate level. This is because certain measures were considered as harmful pursuant to the Code of Conduct.<sup>143</sup> However, the context of the tax package led the Council to ask for a comprehensive study on company taxation in the EU to be undertaken by the Commission.

In 2000, the European Council established the ‘Lisbon Strategy’, with the principal objective of making the EU the world’s most competitive and dynamic economy.<sup>144</sup> This was followed in 2001 by an in-depth study conducted by the European Commission on company taxation in the EU, in concert with a Communication to the European Council.<sup>145</sup>

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<sup>140</sup> Conclusions of the ECOFIN Council Meeting on 1 December 1997 on taxation policy (Resolution of the Council and the Representatives of the Governments of the Member States) OJ C 2, 06/01/1998 p.1.

<sup>141</sup> Council Directive 2003/48/EC of 3 June 2003 on taxation of Savings Income in the form of Interest payments OJ L 157, 26.6.2003, pp. 38–48.

<sup>142</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to Interest and Royalty payments made between associated companies of different Member States, OJ L 157, p.49.

<sup>143</sup> Philippe Cattoir, ‘A History of the “Tax Package” the Principles and Issues underlying the Community approach (2006) European Commission Working Paper No 10.

<sup>144</sup> See European Council of Lisbon, March 2000, pt.5,

at <[http://www.europarl.europa.eu/summits/lis1\\_en.htm](http://www.europarl.europa.eu/summits/lis1_en.htm) > ; <

[http://ec.europa.eu/growthandjobs/index\\_en.htm](http://ec.europa.eu/growthandjobs/index_en.htm) > accessed February 2013.

<sup>145</sup> Commission, ‘Towards an Internal Market without tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, (Communication) COM (2001)582 final.

### 2.2.3 The Commission's study on company taxation in the EU

A mandate was given to the Commission to conduct a study on company taxation in the European Community.<sup>146</sup> According to this mandate, the Commission was committed to highlighting the remaining tax obstacles to EU-wide business activities, and was asked to analyse the differences between the effective levels of corporate tax in Member States. In this respect, the conclusions of the Ruding Committee Report 1992 were to be taken into consideration. The study was to examine the influence of corporate tax bases on an effective level of taxation. In addition, the Commission was asked to identify the main tax provisions which might hinder cross-border businesses in the Internal Market, particularly the impact of tax on the location of economic activities and investment. The Commission was required to identify the tax policy that would reduce taxation and to suggest possible remedial measures that would not affect tax competition in the Community.<sup>147</sup>

Generally, the study indicated that the globalisation process has profoundly changed the international economic landscape in the EU.<sup>148</sup> Moreover, the introduction of the Internal Market and the introduction of Economic and Monetary Union has significantly changed the scenario for the company tax systems of Member States and accordingly created new challenges for domestic company tax systems.<sup>149</sup> Accordingly, it was concluded that company taxation constitutes one of the most important remaining issues

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<sup>146</sup> Following the Vienna European Council of 11 and 12 December 1998, the mandate of this study was given to the Commission as follows;

‘The Commission is invited to present an analytical study of company taxation in the European Community. This study will be undertaken in the general context of the Vienna European Council conclusions emphasizing the need to combat harmful tax competition whilst taking into account that corporation in the tax policy area is not aiming at uniform tax rates and is not consistent with fair tax competition but is called for to reduce the continuing distortion in the single market also in the view of stimulating economic growth, and enhancing the international competitiveness of the community, to prevent excessive losses of tax revenue or to get tax structures to develop in a more employment-friendly way. This study will also be undertaken on the basis of ECOFIN Council conclusions asking to illuminate existing differences in effective corporate taxation in the Community and the policy issues that such differences may give rise to....’

see Vienna European council 11 and 12 December 1998, presidency conclusions, Point 21 at <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/00300-R1.EN8.htm](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00300-R1.EN8.htm)> accessed 7 February 2013.

<sup>147</sup> European Commission, ‘Company Taxation in the Internal Market’, SEC (2001) 1681 final. p. 2.

<sup>148</sup> *Ibid.*, p.20.

<sup>149</sup> See Frans Vanistendael, ‘Redistribution of Tax Law-making Power in EMU?’ *EC Tax Review*, Vol.7, Issue 2, 1998, pp. 74–79.

for the completion of the Internal Market and the full integration of the economies of the Member States.<sup>150</sup>

The study identifies several remaining tax obstacles to cross-border economic activity in the Internal Market. These obstacles are related to some main issues including taxation of cross-border dividend flows, taxation of cross-border business restructuring, transfer-pricing, cross-border loss compensation and double taxation conventions.<sup>151</sup> These obstacles will be briefly outlined as follows:

#### **2.2.4 Remaining corporate tax obstacles in the EU**

The coexistence of 27 tax systems within the EU is considered to be an onerous obstacle to cross-border activities in the EU.<sup>152</sup> Each Member State is a separate tax jurisdiction with its own domestic set of tax rules including rules for determining taxable profit, and arrangements for collection and administration of tax. Moreover, each Member State has a different network of tax treaties.<sup>153</sup> The need to comply with a multiplicity of different rules entails a considerable compliance cost and excessive administrative burdens for both taxpayers and Member States.<sup>154</sup> Facing this multiplicity of approaches at all levels is a serious obstacle to cross-border economic activities as it involves significant frictional losses and braking effects.<sup>155</sup> The costs and risks associated with corporate tax diversity in the Community may even discourage small and medium-sized enterprises from engaging in cross-border activity. Moreover, the distortive effect of tax uncertainty may occur, as tax systems are changing continuously. Uncertainty has a

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<sup>150</sup> For analysis of the European Commission study on company taxation see Michael P. Deverux, 'Debating Proposed Reforms of the Taxation of Corporate Income in the European Union', *International Taxation and Public Finance*, Vol.11, 2004, pp.71-89.

<sup>151</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final, p.242 et seq.

<sup>152</sup> For more details and figures on the corporate tax obstacles in the EU, see European Commission 'Impact Assessment' SEC (2011)315 final; Sabine D. Selbach, 'The Harmonisation of Corporate Taxation and Accounting Standards in the European Community and their Interrelationship', *Connecticut Journal of International Law*, Vol.18, 2003, p.523.

<sup>153</sup> European Commission, 'Company Taxation in the Internal Market' COM (2001)582 final, p.242.

<sup>154</sup> For figures on such costs see European Commission, 'Impact assessment' SEC (2011)315 final, p.95.

<sup>155</sup> European Commission, *Company taxation in the Internal Market*, COM (2001)582 final, p.242.

negative effect on investment and capital accumulation in the short and long term, which in turn leads to lower investment rates.<sup>156</sup>

The most complicated corporate taxation area that multinational corporations face is transfer-pricing and its issues, especially with the increasing importance of intangibles and internal market integration.<sup>157</sup> The allocation of revenues between related entities resident in different Member States on the basis of separate accounting under the arm's length principle, which lies at the heart of transfer pricing, is a source of double taxation.<sup>158</sup> In this regard, double taxation occurs when the tax administration of one Member State unilaterally adjusts the price set by a company on a cross-border intra-group transaction, without this adjustment being offset by a corresponding adjustment in the other respective Member State. Transfer-pricing under the arm's length concept also creates an unduly high compliance cost; and since it is a cross-border issue, multinational enterprises with cross-border transactions find themselves confronted with several problems, such as increasingly onerous documentation requirements.<sup>159</sup> Furthermore, the high compliance cost results from difficulties of finding "comparables" for benchmark prices. It can be pointed out that transfer-pricing complexities constitute an essential barrier to the smooth functioning of the Internal Market, since they can be used as a tax planning instrument for profit-shifting from a high tax jurisdiction to a low tax one.<sup>160</sup>

More importantly, the absence or limited availability of cross-border loss relief within one company or group of companies is one of the most onerous barriers that impede cross-border economic activities in the Internal Market.<sup>161</sup> While all Member States allow for domestic loss relief in a single company and most Member States allow for domestic relief of losses within a group of companies, only a few Member States

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<sup>156</sup> Krister Andersson, 'An Optional Common consolidated Corporate Tax Base in the European Union' in Andersson, Krister; Eberhartinger, Eva; Oxelheim, Lars (Eds.), *National Tax Policy in the European Union: To be or not to be* (Springer 2008), p.142.

<sup>157</sup> For downsides of transfer pricing see Ilan Benshalom, 'Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-related Transactions', *Virginia Tax Review*, Vol. 26, 2007, p.631.

<sup>158</sup> European Commission, 'Impact Assessment' SEC (2011)315 final, p.10.

<sup>159</sup> Jonathan S. Schwarz, 'European Commission Strategy for Company Taxation in the European Community', Vol. 56, 2002, *Bulletin for International Fiscal Documentation*, pp. 215-218 at 215.

<sup>160</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001) 1681 final, p.242; Martin A.

<sup>161</sup> European Commission, 'Impact assessment' SEC (2011)315 final, p.11.

provide for some limited cross-border loss compensation.<sup>162</sup> Moreover, there are different treatments of foreign permanent establishment and foreign subsidiaries by Member States, which affect business decisions and lead to the risk of over-taxation.<sup>163</sup> The different approaches of Member States on cross-border loss compensation influence business decisions with regard to whether or how to invest in a new market.<sup>164</sup> Consequently, it contradicts the freedom of establishment by going against Art. 49 TFEU and it would have an impact on the functioning of the Internal Market<sup>165</sup> which in turn affects the competitiveness of the EU.<sup>166</sup>

Moreover, the area of double taxation conventions is a source of distortion to the European-wide economic activities.<sup>167</sup> Although the intra-EU network of double taxation treaties is largely complete, nevertheless some gaps remain. Most treaties within the EU follow the OECD Model Convention, but there are significant differences in the provisions of the various treaties and their interpretation. There are also instances of divergent application of treaties by the treaty partners, leading to double taxation or non-taxation.<sup>168</sup> Furthermore, the flow of cross-border income between associated companies creates an obstacle to cross-business activities within the Internal Market. Payments of interest and royalties between associated companies of different Member States are often still subject to withholding taxes, which mostly create situations of double taxation.<sup>169</sup>

In order to deal with the above-mentioned tax obstacles, the European Commission outlined a reform strategy. The Commission emphasised the need for a European corporate tax system with a common consolidated tax base for multinational enterprises.<sup>170</sup> In order to deal with the corporate tax obstacles in the EU, the 2001 study

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<sup>162</sup> For more on the loss compensation in the EU, see European Commission, 'Tax Treatment in Cross-border Situations' COM (2006)842 final.

<sup>163</sup> Maria Soledad Gonzalez-Marquez 'The Tax Treatment of Losses in cross-border situations' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008), p.865.

<sup>164</sup> European Commission, 'Tax Treatment in Cross-border Situations' COM (2006)842 final.

<sup>165</sup> European Commission, 'Impact Assessment 'SEC (2011)315 final, p.12.

<sup>166</sup> European Commission, 'Company Taxation in the Internal Market' COM (2001)582 final, p.250.

<sup>167</sup> Jonathan S. Schwarz, 'European Commission Strategy for company taxation in the European Community', Vol. 56, 2002, *Bulletin for international Fiscal Documentation*, pp. 215-218 at 215.

<sup>168</sup> European Commission, 'Company Taxation in the Internal Market' COM (2001)582 final, p.250.

<sup>169</sup> *Ibid.*

<sup>170</sup> European Commission, 'Towards an Internal Market without tax Obstacles: A strategy for providing Companies with a consolidated tax base for their EU-wide activities' (Communication)COM(2001)582

distinguished between targeted remedies and comprehensive remedies. The targeted remedies would be launched on the basis of a separate analysis of the obstacles one by one in order to find a targeted solution for each identified obstacle. The comprehensive remedies sought to make a major change in the tax system of each Member in order to provide an all-embracing remedy which would minimise, or remove completely, the obstacles by employing a more combined approach.<sup>171</sup> The Commission stressed that it would support both types of remedies, but as regards targeted remedies it was concluded that these would only contain a partial solution since they would not tackle the pressing obstacle of the existence of separate domestic tax systems.<sup>172</sup>

The comprehensive remedies include four alternatives: Home State Taxation (HST), the CCCTB, European Union Company Income Tax, and a single compulsory 'Harmonised Tax Base'. The 'European Union Company Income tax', provides for a uniform EU tax base and rate, accordingly the revenue would go to the Community budget and be apportioned by an agreed formula.<sup>173</sup> The 'Compulsory Harmonised Tax Base' recognises the need for a replacement of the domestic tax systems with a harmonised EU-company tax system.<sup>174</sup> However, the four alternatives require apportionment formulas to allocate the formulated tax base between group members resident in different Member States. For corporate tax consolidation the Commission presented the HST and the CCCTB.<sup>175</sup>

The underlying concept of HST<sup>176</sup> is that the profits of a group of companies operating in more than one Member State are computed pursuant to the rules of one company tax system, which is the system of the Home State in which the headquarters of the group is located. This requires the agreement of participating Member States to accept each other's rules for calculating taxable income of national groups of companies. Each

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final,p.7; European Commission, 'An Internal Market without Tax obstacles: achievements , ongoing initiatives and remaining challenges' COM(2003)726,p.5.

<sup>171</sup> European Commission, 'Company Taxation in the Internal Market' COM (2001)582 final, p.306.

<sup>172</sup> European Commission, 'An Internal Market without Tax obstacles: achievements, ongoing initiatives and remaining challenges' COM (2003)726, p.3.

<sup>173</sup> European Commission, 'Towards an Internal Market without Tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities' COM (2001)582.final, p.5 et seq.

<sup>174</sup> European Commission, Company Taxation in the Internal Market, SEC, 1681(COM 582 final, p.307.

<sup>175</sup> Vieri Ceriani and Silvia Giannini, 'Trends in the EU Proposals on Taxation of Transitional business Profits and Tax Coordination' WTD, 2003, p.178.

<sup>176</sup> For the origin of the HST see Sven Olof Lodin and Malcolm Gammie, 'The Taxation of European Company', European Taxation, Vol.8, 1999, p286.



participating Member State would continue to tax its share of the profits of the group's business activities at its own tax rate.<sup>177</sup> HST was meant to be suitable for small and medium-sized enterprises (SME).<sup>178</sup>

The HST is considered to be a small step towards the integration of EU corporate income tax. Following a number of public convergences and consultations, including consultations on the possible use of IFRS as a starting point for a common EU tax base,<sup>179</sup> the CCCTB strategy, which is the main focus of this research, appeared to be the best option for a systematic elimination of tax obstacles that hinder cross-border activities. This was confirmed several times.<sup>180</sup> The CCCTB was the one mainly intended by the Commission.<sup>181</sup>

In 2004 the CCCTB concept was developed by a working group along with more six sub-groups.<sup>182</sup> The work of the working groups was supplemented in very different ways, such as the academic contribution, comments from business organisations and meetings.<sup>183</sup> In 2007 the Commission prepared a working paper on the possible elements of a technical outline of the CCCTB by beginning to bring the various structural elements of the base together into a coherent set of rules.<sup>184</sup>

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<sup>177</sup> Olof Lodin and Malcolm Gammie, *Home State Taxation* (Amsterdam: IBFD 2000), p.41; Ilan Benshalom, 'A Comparative Solution for Targeted Problem: A Critique of the European Union's Home State taxation Initiative', *European Taxation*, December 2008, pp.630-641.

<sup>178</sup> European Commission, 'An Internal Market without Tax obstacles: achievements, ongoing initiatives and remaining challenges' COM (2003)726, p.12; European Commission, 'Tackling the Corporation Tax Obstacles of Small and medium-sized Enterprises in the Internal Market-Outline of Possible Home States Taxation' (Communication) SEC (2005)1785, p15.

<sup>179</sup> See <[http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm)> accessed 5 February 2013.

<sup>180</sup> European Commission, COM (2003)726; European Commission, COM (2005)532 final; European Commission COM (2006)157final; European Commission, 'Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the CCCTB' COM (2007) 223 final.

<sup>181</sup> European Commission, COM (2007)223 final.

<sup>182</sup> Commission Non-Paper to informal ECOFIN Council, 10 and 11 September 2004, p.2, available at <[http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm)> accessed 5 February 2013.

<sup>183</sup> The documents of Meetings of the Working Group on the Common Consolidated Corporate Tax Base (CCCTB WG) available at <[http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm)> accessed 6 February 2012.

<sup>184</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline' (CCCTB/WP057\doc\en, 26 July 2007).

On 16 March 2011, the European Commission finally released a Directive Proposal on the CCCTB along with a detailed analysis on the impact assessment of the CCCTB. With the proposed Council Directive, the Commission aimed to establish a fundamental change of corporate taxation in Europe in order to diminish existing inefficiencies and distortions resulting from the coexistence of 27 different tax regimes.<sup>185</sup> The main aspects of the CCCTB system will now be analysed in depth.

### 2.3 The objectives of the CCCTB project

The CCCTB is a proposed system of standardised rules for computing the tax base of a corporate group with subsidiaries and/or permanent establishments in Member States of the EU.<sup>186</sup> The CCCTB allows an EU group of companies to consolidate its profits and losses. This consolidated figure is then allocated by means of an apportionment formula to the group members in the Member States in which the group has a taxable presence.<sup>187</sup> For the purposes of calculating the tax due in each Member State, the Member States concerned have the opportunity to apply their own national tax rates to the allocated amounts of the consolidated tax base.<sup>188</sup>

The main general objective of the CCCTB is to help in fulfilling the set of objectives derived from the basic policy of European Treaties. These objectives include, for instance, the realisation of the Internal Market.<sup>189</sup> It also aims to contribute to the Lisbon Strategy and goals, i.e. achieving the enhancement of growth and jobs and competitiveness within the EU.<sup>190</sup> The CCCTB is in accordance with the priorities set

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<sup>185</sup> The full Draft Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) is available at

<[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/com\\_2011\\_121\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf)> accessed 10 November 2012.

<sup>186</sup> See Art (1) of the CCCTB Directive. For more on the CCCTB system see Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008).

<sup>187</sup> Art. 826 to 102 of the CCCTB Directive.

<sup>188</sup> Art.103 of the CCCTB Directive.

<sup>189</sup> Ulli A. Konrad, 'The Common Consolidated Corporate Tax Base in the European Union', *Bulletin for International Taxation*, May/June 2009, p. 252.

<sup>190</sup> European Commission, 'The Contribution of Taxation and Customs Policies to the Lisbon Strategy' COM (2005) 532 final, p.3.; European Commission, 'Implementing the Community Lisbon Programme: Progress to date and Next Steps towards Common Consolidated corporate tax base' COM (2006) 157 final, p.3; European Commission, 'Implementing the Community Programme for Improved Growth and Employment and the Enhanced Competitiveness of the EU Business' COM (2007) 223 final.

out in Europe 2020 Strategy.<sup>191</sup> The CCCTB is a crucial step towards the completion of the Internal Market.<sup>192</sup>

Considering that the CCCTB applies in the field of corporate taxation, it has been designed to eliminate or at least to reduce the existing tax obstacles to companies undertaking business in the EU. The objective of the CCCTB is summarised by the European Commission as “a comprehensive solution to tackle in one go all the company tax obstacles arising when companies carry out cross-border activities within the Internal Market”<sup>193</sup>. This means that the CCCTB is needed in order to decrease the compliance costs of European multinational enterprises, eliminate the existing transfer-pricing problems, allow for the consolidation of profits and losses, avoid many situations of double taxation and remove many discriminatory situations and restrictions. The CCCTB would contribute to greater efficiency, effectiveness, simplicity and transparency in company tax systems and remove the hiatuses between domestic systems.<sup>194</sup> It is needed as a remedial comprehensive approach in order to tackle the majority of the tax obstacles to European-wide economic activities by a single framework, compared to targeted measures solution, which offer remedies for some tax obstacles but do not address the underlying problem of the coexistence of 27 different tax systems.<sup>195</sup> The introduction of the CCCTB system with formulary apportionment is a big step from separate accounting with the arm’s length pricing method to a new approach for allocating income across the EU.<sup>196</sup>

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<sup>191</sup> European Commission, ‘Europe 2020- A Strategy for Smart, Sustainable and Inclusive Growth’ (Communication) COM (2010) 2020, 3.3.2010.

<sup>192</sup> European Commission, ‘Towards a Single Market Act- for highly competitive social market economy -50 proposals for improving our work, business and exchanges with one another.’(Communication) COM (2010)608.

<sup>193</sup> Common consolidated corporate tax base, working group, 2007, internal letter from the European commission, p.1.

<sup>194</sup> European Commission, ‘Implementing the Community Lisbon Programme: Progress to date and Next steps towards Common Consolidated corporate tax base’ COM (2006) 157 final, p.3

<sup>195</sup> European Commission, ‘Implementation of the community Lisbon programme, the contribution of Taxation and Customs Policy to the Lisbon strategy, COM (2005)532 final, p.4.

<sup>196</sup> European Commission, ‘The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options’ (2006) Working paper No.9/2006,p.44.

## **2.4 The common consolidated corporate tax base features**

### **2.4.1 The legislative basis for the CCCTB**

In principle, the EU Directives are binding, as regards the result to be reached upon each Member State, ‘but leave to the national authorities the choice of form and methods’. In contrast, a Regulation is ‘binding in its entirety and directly applicable in all Member States’.<sup>197</sup>

On the one hand, the CCCTB could have been introduced in the form of a Regulation, given that the aim of the comprehensive approach was to provide a complete code for corporation tax at the European level. However, a Directive would not normally provide such a code and would leave the details to be provided by Member States. However, it was concluded that there was no legal basis for a Regulation because the Directive is based on Article 115 of the TFEU. Under this article, the law approximation process which directly affects the establishment or the function of the Internal Market is only allowed to take the form of a Directive. Moreover, it was recognised that it would be difficult to lay down every detailed rule in a basic instrument like a Regulation.<sup>198</sup>

The CCCTB Directive aims at the harmonisation of the national corporate tax provisions of Member States with a view to removing obstacles to the internal market. As a consequence, the proposal directly affects the functioning of the Internal Market and consequently falls under the ambit of Article 115 of the TFEU. Therefore, Article 115 provides a relevant and sufficient legal basis for adopting the CCCTB in the form of a Directive.<sup>199</sup>

Furthermore, in the context of corporate law, issuing the CCCTB scheme in the form of a Directive is important in order to secure an adequate level of legal certainty both for taxpayers and for tax administrations. In other words, the taxable base is defined by law; that is, the determination of the taxable base is part of the legislation of each State.

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<sup>197</sup> Art.288 of the TFEU.

<sup>198</sup> European Commission, ‘CCCTB: Possible Elements of a Technical Outline’ (CCCTB/WP057/doc/en, 26 July 2007), p.4.

<sup>199</sup> See Memo of the CCCTB Directive, p.9.

Thus, if the CCCTB legal instrument is based on soft law such as a recommendation or agreement it would open the door to tax uncertainty.<sup>200</sup> A directive is an instrument best suited to guaranteeing basic common rules that are applicable in all Member States, and it fully respects the proportionality principle.<sup>201</sup> However, the only problem with the CCCTB Directive is the unanimity requirement, which could be an obstacle to the adoption of CCCTB as a system.<sup>202</sup>

#### 2.4.2 Optional CCCTB

The CCCTB is an optional system,<sup>203</sup> meaning that businesses are given the opportunity to opt out or into the CCCTB regime. An optional system implies that companies will have the choice to have their taxable base computed under the CCCTB rules or to remain fully governed by the domestic tax systems.<sup>204</sup> The CCCTB Directive stipulates that a company opting for the CCCTB system shall cease to be subject to the national corporate tax system with regard to all issues regulated by the CCCTB Directive<sup>205</sup>. This will include rules for computing the tax base, and many of the procedural aspects of corporate tax, but tax rates are not governed by the Directive. Consequently, the countries concerned will not have to administer two corporate tax systems in tandem.<sup>206</sup>

An optional system is preferable as it does not compel those companies that are not interested in the CCCTB to incur the unnecessary cost of adapting to a new system, which could outweigh the benefits of the CCCTB, especially for small and medium-sized enterprises. An optional CCCTB would keep the tax competition between national tax systems.<sup>207</sup> In contrast, a compulsory CCCTB would not be in line with the

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<sup>200</sup> European Commission, 'Impact Assessment' SEC (2011)315 final, p.19.

<sup>201</sup> *Ibid.*, p.20.

<sup>202</sup> Ulli A. Konrad, 'The Common Consolidated Corporate Tax Base in the European Union', *Bulletin for International Taxation*, May/June 2009, p. 252.

<sup>203</sup> Art.6 of the CCCTB Directive; For pros and cons of the optionality of the CCCTB see Johanna Hey, 'CCCTB-optionality' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008),p.93.

<sup>204</sup> Art.7 of the CCCTB Directive.

<sup>205</sup> *Ibid.*

<sup>206</sup> Schoen, Wolfgang, 'Group Taxation and the CCCTB', *Tax Notes International*, Vol. 48, No. 11, 2007, pp. 1063-1080 at 1070, available at <SSRN: <http://ssrn.com/abstract=1577037>> accessed 20 November 2012.

<sup>207</sup> See Krister Andersson, 'An optional and competitive CCCTB – A comprehensive Approach to reach the Lisbon objectives' in Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), pp.96-97.

principle of ‘subsidiarity’ as it would mean that EU measures such as the CCCTB were being introduced to cover purely domestic as well as EU-level activities.<sup>208</sup> However, optionality does not include ‘cherry-picking’ for businesses; namely, including some entities and leaving others outside the CCCTB. Where the option to apply the CCCTB is exercised, all permanent establishment and qualifying subsidiaries of a parent company are automatically consolidated, i.e. ‘All-in or all-out concept’.<sup>209</sup> However, a stand-alone company with no cross-border activities via permanent establishments or subsidiaries can opt for the CCCTB only with respect to rules for calculating the tax base.<sup>210</sup>

### **2.4.3 Personal scope of the CCCTB within the EU**

Since the aims of the CCCTB are to eliminate as wide a range of corporate tax obstacles as possible, the intention is to make the personal scope of the CCCTB as wide as possible.<sup>211</sup> The CCCTB Directive applies to companies irrespective of their size, ranging from small and medium-sized enterprises to large corporate groups.<sup>212</sup> The scope of the CCCTB includes permanent establishment as well as subsidiaries, as any distinction between subsidiaries and permanent establishments would open the door to tax planning, simply by choosing the legal form of company that covered or was excluded from the CCCTB scope.<sup>213</sup>

Under the CCCTB Directive, the system applies when a company is established under the laws of a Member State, has a qualifying corporate form and is subject to the corporate tax of a specified EU Member State. Companies satisfying these conditions would be ‘eligible companies’ to be covered by the CCCTB.<sup>214</sup> Qualifying corporate forms and corporate taxes are listed in Annexes I and II of the Directive respectively. This approach is similar to those of the EU Parent-Subsidiary Directive and the EU

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<sup>208</sup> European Commission, ‘Personal Scope of CCCTB’ (CCCTB\WP\040\doc\en, 2006), p.2.

<sup>209</sup> Arts.54 and 55 of the CCCTB Directive.

<sup>210</sup> See Memo of the CCCTB Directive, p.5.

<sup>211</sup> European Commission, ‘Personal Scope of CCCTB’ (CCCTB\WP\040\doc\en, 2006), p.2; European Commission, ‘An Overview of the Main Issues that emerged at the third meeting of the subgroup on group taxation (SG-05-06 February 2007) Working Document,p.5.

<sup>212</sup> See Memo of the CCCTB Directive, p.5.

<sup>213</sup> Caresten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union*, (Gabler 2009), p.164.

<sup>214</sup> See Art.2(1) of the CCCTB Directive

Interest and Royalty Directive. However, the CCCTB list regarding the eligible companies will be dynamic, as both annexes may be amended.<sup>215</sup> However, it should be noted that companies are treated differently under Annex I. The list of legal forms is exhaustive for some states, but in other cases a general clause is provided.<sup>216</sup>

With regard to the treatment of transparent entities, the initial view was not to include them in the personal scope of the CCCTB.<sup>217</sup> According to most countries' corporate tax systems, the corporate income is not fully integrated into the personal income tax of shareholders because the corporations are distinct legal entities, which are taxed separately from their shareholders.<sup>218</sup> The inclusion of transparent entities in the CCCTB would contravene the distinction between personal income tax and corporate income tax drawn by the corporate tax systems of Member States, and would impact on the revenue of personal income tax.<sup>219</sup> This is because the effects of consolidation and formula apportionment would extend to the personal income tax, and this is not intended by the European Commission.<sup>220</sup>

Although the transparent entities are not included in the personal scope of the CCCTB, they are still involved in the CCCTB setting. Therefore, the CCCTB Directive excludes the transparent entities from the personal scope of the CCCTB, but it has provisions regarding the allocation of their income to taxpayers holding an interest in them.<sup>221</sup> If a company is included in the personal scope of the CCCTB – in other words, it is a CCCTB taxpayer holding an interest in an entity which is treated as transparent in a Member State of its location – its share of the income of the transparent entity will be included in its tax base.<sup>222</sup>

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<sup>215</sup> Art.2 (3) of the CCCTB Directive.

<sup>216</sup> Lang Michal, 'The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base' (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.5.

<sup>217</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline' (CCCTB/WP057/doc/en, 26 July 2007), p.20.

<sup>218</sup> Caresten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union*, (Gabler 2009), p.74.

<sup>219</sup> *Ibid*, p.165.

<sup>220</sup> European Commission, 'Tax Policy in the European Union – Priorities for the Years Ahead,' (Communication) COM (2001), 260 final, p-17.

<sup>221</sup> Art.84 of the CCCTB Directive.

<sup>222</sup> Art.84 (1) of the CCCTB Directive.

The transactions between the CCCTB taxpayer and the transparent entity will be disregarded in proportion to the taxpayer share of the transparent entity. Consequently, the taxpayer's income resulting from such transactions will be regarded as a proportion of the amount which would be agreed between independent enterprises; that is, on an arm's length basis.<sup>223</sup> It should be stressed that the personal scope of the CCCTB with regard to entities resident in third countries will be discussed in the next chapter.

## **2.5 Structure of the common consolidated corporate tax base in the EU**

Under the CCCTB scheme, the tax liability in each CCCTB-Member State is computed by implementing three consecutive stages. Firstly, every individual company resident in a different Member State will calculate its separate tax base using a *common set of tax rules*.<sup>224</sup> The separate taxable income of the member of a group is then *consolidated* when the required conditions for consolidation are available.<sup>225</sup> The common consolidated tax base that results from the consolidation is *redistributed* to the respective entities of the CCCTB group according to the formulary apportionment.<sup>226</sup> After the apportionment, the tax rate is not harmonised, meaning that each Member State will apply its corporate tax rate because there is no common European corporate tax rate.<sup>227</sup> Thus the CCCTB acronym reflects the following elements:

*Common:* One single set of rules for companies operating in all EU Member States.

*Consolidated:* EU-wide consolidation of a group's profits and losses.

*Corporate:* The proposal only affects companies.

*Tax Base:* The amount of the group's profit or loss chargeable to tax.

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<sup>223</sup> Art.84 (2) of the CCCTB Directive.

<sup>224</sup> See Arts.9 to 43 of the CCCTB Directive; Clemens Fuest, 'The European Commission Proposal for a Common Consolidated Corporate Tax Base' (2008) Oxford University Centre for Business Taxation Working Paper 08/23, p.2.

<sup>225</sup> See Arts. 54to 60 of the CCCTB Directive; Nerudova, D., Common Consolidated Corporate Tax Base: Grouping and Consolidation. Acta univ. agric. et silvic. Mendel. Brun., Vol. LX, issue 2, 2012,pp. 237–244

<sup>226</sup> Arts. 86 to102 of the CCCTB Directive; for more details see Petutschnig, Matthias, 'Common Consolidated Corporate Tax Base: Effects of Formulary Apportionment on Corporate Group Entities'(2010).Discussion Papers No 38, available at< <http://epub.wu.ac.at/428/>> accessed 10 February 2013; Petutschnig Matthias, 'Sharing the Group Benefits of a Common Consolidated Corporate Tax Base within Corporate Groups (May 4, 2011). Available at <SSRN: <http://ssrn.com/abstract=1831103>> accessed 11 February 2013.

<sup>227</sup> Art.103 of the CCCTB Directive.



### 2.5.1 A common tax base

According to the concept of the CCCTB, one set of common rules is followed in order to determine the corporate tax bases within the EU. The European Commission considered that the common rules could be established by using the International Financial Reporting Standard (IFRS) for calculation of the tax base.<sup>228</sup>

#### 2.5.1.1 International Financial Reporting Standards (IFRS) and common tax base rules

Regarding the relationship between financial accounting and tax accounting, in most Member States the determination of taxable income is based on financial profit or loss, and reference or adjustment are made to domestic Generally Accepted Accounting Principles (GAAP).<sup>229</sup> Normally, there is common ground between tax accounting and financial accounting. In most of the EU Member States the financial accounting constitutes a wide basis for common tax accounting rules; that is, the framework and tax system principles in general.<sup>230</sup> In particular, specific accounting principles such as the definition of assets and liabilities, and also recognition of profit taxation, are based on the realisation principle in all Member States.<sup>231</sup> The main aim of the IFRS is to provide useful decision-making information to the participants in the capital market about the financial position and performance of an enterprise, and any changes in its financial

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<sup>228</sup> European Commission, 'The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax base for Companies' EU-Wide activities'(2003) Consultation Document available at <[http://ec.europa.eu/taxation\\_customs/common/consultations/tax/article\\_385\\_en.htm](http://ec.europa.eu/taxation_customs/common/consultations/tax/article_385_en.htm)> accessed 10 February 2013; Bob van der Made, 'The CCCTB - Coming soon to a Theatre near you', International Tax Review, January 2007, p.1 at <<http://search.proquest.com.vezproxy.brunel.ac.uk:2048/docview/230192903?accountid=14494>> Accessed 10 February 2013.

<sup>229</sup> Judith Freedman Graeme Macdonald, 'The Tax Base for the CCCTB: The Role of the Principles' (2007) Oxford University Centre for Business Taxation Working Paper 08/07, p.5.

<sup>230</sup> Andreas Oestreicher and Christoph Spengel, 'Tax Harmonisation in Europe: The Determination of Corporate Taxable income in the Member States', European Taxation, October 2007, pp437-451 at 439; for more on the possibility of establishing CCTB on IFRS see Wolfgang Schoen, 'International Accounting Standards – A “Starting Point” for a Common European Tax Base?' European Taxation, Vol.44, 2004 p.426.

<sup>231</sup> Otto Hechristoph Spengel, Thorsten Stetter and Carsten Wendt , 'EU Company Taxation in Case of a Common Tax Base :A Computer-Based Calculation and Comparison Using the Enhanced Model of the European Tax Analyser' (2005) Discussion paper No 05-37, ZEW,p.20, available at <<ftp://ftp.zew.de/pub/zew-docs/dp/dp0537.pdf>> accessed 11 February 2013.

position. Tax accounting, on the other hand, seeks to compute a reliable and fair base for income taxation.<sup>232</sup>

The attractiveness of the idea of using the IFRS as a starting point for a Common Corporate Tax Base emerged in 2002, as EU-parent listed companies were obliged to draw up their consolidated accounts in accordance with the IFRS as from 2005. Companies whose current accounts are in accordance with US-GAAP were to use the IFRS from 2007.<sup>233</sup> According to the Commission's Regulation (EC) No1358/2007, the scope of the IFRS extends to both the individual financial statements of an entity and the consolidated financial statements of a group of companies.<sup>234</sup> Moreover, several regulations have been enacted since 2003, transforming most standards into genuine European law, and many accounting Directives have been amended to support the linkage between the accounting Directives and the IFRS.<sup>235</sup>

The implementation of IFRS in the EU led the European Commission to consider using IAS/IFRS as a starting point for the CCCTB.<sup>236</sup> In principle, the IFRS could be used as an instrument for designing a Common Tax Base since they provide for a common ground and definition for most of the elements of the tax base. However, it is submitted that the IFRS is not appropriate as a guide for some elements of the tax base, as the direct link between the IFRS and tax accounting is not sufficiently strong.<sup>237</sup>

Furthermore, other objections have been submitted in respect to the use of the IFRS for the CCCTB.<sup>238</sup> For example, it is argued that the IAS Committee being a private body would raise the question of whether the CCCTB Directive should be designed by

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<sup>232</sup> Malcolm Gammie, *Achieving a Common Consolidated Corporate Tax base in the EU* (CEPS 2005) p.8

<sup>233</sup> See Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, 11 September 2002, O J L 243, p.1.

<sup>234</sup> See Commission Regulation (EC) No 1358/2007, OJ L304, p.9.

<sup>235</sup> Directive 2003/51/EC enacted by the European Parliament and the Council amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, 17.7.2003, OJ L 178, p.16.

<sup>236</sup> Christoph Spengel, 'International Accounting Standards, Tax Accounting and Effective Levels of Company Tax Burdens in the EU', *European Taxation*, 2003, p. 253 et seq.

<sup>237</sup> European Commission, *Implementing the Community Lisbon Programme: Progress to Date and Next Steps towards a Common Consolidated Corporate Tax Base* COM (2006)157 final, p.7; Andreas Oestreicher and Christoph Spengel, 'Tax Harmonisation in Europe: The Determination of Corporate Taxable income in the Member States', *European Taxation*, October 2007, p.450.

<sup>238</sup> European Commission, COM (2006) 157 final, p.7.

private organisations or not. Also, the IAS/IFRS are not implemented by all Member States with regard to separate company accounts.<sup>239</sup>

The proposed Council Directive introduces independent rules for computing and determining the tax base of companies and does not interfere with financial accounts. It also cuts all formal connections between financial and tax accounting; in other words it does not make a formal link or a reference either between domestic tax accounting principles (GAAP) or between IAS/IFRS and the CCCTB.<sup>240</sup>

Currently, most EU companies use financial accounts as the basis for computing their corporate tax base.<sup>241</sup> This is likely to continue under the CCCTB: companies will continue drawing up their individual accounts using existing accounting rules or using local GAAP, especially in relation to matters where uniform treatment is not regulated by the proposed Council Directive.<sup>242</sup> In this respect, Member States can bring the financial accounts into line with the CCCTB rules by using adjustments or ‘bridges’. Nonetheless, the Directive does not lay down rules for these bridges between all the different domestic GAAPs. Therefore it will be up to each Member State to decide how it will implement the rules, which in turn could result in many different sets of bridges.<sup>243</sup> The European Commission has acknowledged the difficulty, but has stated that it is inevitable,<sup>244</sup> as there is no accounting harmonisation in the EU. Therefore it is critical for the CCCTB Directive to provide a comprehensive set of general principles and rules that will encompass all aspects of determining the common tax base in order to guarantee a uniform application of the CCCTB within all the Member States of the EU.<sup>245</sup>

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<sup>239</sup> European Commission, ‘CCCTB: Possible Elements of a Technical Outline’ (CCCTB/WP057/doc/en, 26 July 2007), p.5.

<sup>240</sup> European Commission, COM (2006) 157 final, p.7.

<sup>241</sup> Spengel, Christoph; Ortmann-Babel, Martina; Zinn, Benedikt; Matenaer, Sebastian, ‘A Common Corporate Tax Base for Europe: An Impact Assessment of the draft Council Directive on a CC(C) TB’ (2012) ZEW Discussion Papers, No. 12-039, <<http://hdl.handle.net/10419/59576>>,p.7.

<sup>242</sup> Art.7 of the CCCTB Directive.

<sup>243</sup> Judith Freedman and Graeme Macdonald, ‘The Tax Base for CCCTB: The Role of Principles’, in: Lang, M., Pistone, P., Schuch, J., Staringer, C. (Eds.), *Common Consolidated Corporate Tax Base*, (Linde 2008), pp. 219-270, at 232.

<sup>244</sup> European Commission, Summary Record of the Meeting of the Common Consolidated Corporate Tax base’ (2007) Working Paper, CCCTB/WP/059/draft/en,p.4.

<sup>245</sup> Spengel, Christoph; Ortmann-Babel, Martina; Zinn, Benedikt; Matenaer, Sebastian, ‘A Common Corporate Tax Base for Europe: An Impact Assessment of the draft Council Directive on a CC(C) TB’ (2012) ZEW Discussion Papers, No. 12-039, <<http://hdl.handle.net/10419/59576>>,p.5.

Moreover, having said that the IAS/IFRS have clearly been used as guidance in developing the common tax base rules because they ‘provide a common language and some common definitions’,<sup>246</sup> it is essential for the proposed CCCTB Directive to clarify to what extent the guidance contained in the IFRS can be used as a basis for interpreting the CCCTB rules to determine the common tax base.

### **2.5.1.2 Determining the individual tax base under the CCCTB system**

The CCCTB system introduces autonomous rules for the determination of the tax base of companies. It is beyond the scope of this thesis to provide the entire set of accounting rules for calculating the common tax base. However, the general principles of tax base calculation are briefly addressed.<sup>247</sup> It should be pointed out that the common tax rules for calculating the corporate tax base are intended for a single, stand-alone company; that is to say, the tax base of an individual company, either a group member or a company which is not qualified for consolidation,<sup>248</sup> but which has opted for CCCTB.<sup>249</sup>

Under the CCCTB, the tax base includes all income subject to taxes; namely, gross income less exempt income (such as the gains from the disposal of pooled assets and dividends and gains from the disposal of shares)<sup>250</sup> and less deductible expenses and other deductible items.<sup>251</sup> In other words, all revenues are included in the tax base except items that are explicitly exempted. Moreover, expenses and other specific items are deducted from the taxable revenues as deductible. Exempt items include: received distributions of dividends; proceeds from the disposal of shares; and income from a branch of the company in a third country. Deductible business expenses commonly involve all costs relating to sales and also expenses linked to the production, maintenance and securing of income.<sup>252</sup> The CCCTB extends deductibility to costs for

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<sup>246</sup> European Commission, COM (2006) 157 final, p.7.

<sup>247</sup> For detailed analysis on the tax base calculation under the CCCTB system see Christoph Spengel and York Zöllkau (Eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income: An International Comparison* (Springer 2012), p.21.

<sup>248</sup> Art. 4(2) of the CCCTB Directive, it defines the single taxpayer as a company opted for the CCCTB but not fulfilling the requirement of consolidation.

<sup>249</sup> Arts. 54, 55 of the CCCTB Directive.

<sup>250</sup> See Art.11 of the CCCTB Directive.

<sup>251</sup> See Art.10 of the CCCTB Directive; European Commission, ‘CCCTB: Possible Elements of a Technical Outline’ (CCCTB/WP057/doc/en, 26 July 2007), p.7.

<sup>252</sup> Art.12 of the CCCTB Directive.

research and development (R&D) and for raising equity or debt for the purposes of the business.<sup>253</sup>

Fixed assets are depreciable for tax purposes, subject to certain exceptions. As regards depreciable assets, a distinction is made between those subject to depreciation individually and those placed in a pool: long-life tangible and intangible fixed assets are individually depreciated while the remaining assets go into a pool.<sup>254</sup> Furthermore, losses may be carried forward indefinitely, but loss carry-back is not allowed.<sup>255</sup>

The tax base is determined on an annual basis and the income and losses are only accrued when they occur, meaning that the accrual principle is adopted, and the taxable transactions are not treated as being on a pooled basis; that is, they are measured individually.<sup>256</sup> The term ‘profit and loss’ is used with reference to the realisation principle: ‘profits and losses shall be recognised only when realised.’<sup>257</sup> The aim appears to be that income and expenses would be recognised on an accruals basis in the tax year to which they relate. This reflects general accounting practice and corresponds to the IFRS framework, under which the effects of transactions and other events are recognised when they occur.<sup>258</sup>

The CCCTB computation rules adopt a ‘profit and loss’ approach rather than a ‘balance sheet’ approach. Unlike some national tax systems, they do not determine the taxable income by comparing the beginning of year balance with the balance of the end of the year. Instead, the CCCTB Directive focuses on a company’s profit and loss position.<sup>259</sup> The principle of ‘All revenues should be taxable unless expressly exempted’<sup>260</sup> is seen as being in line with economic neutrality, which requires complete generality with exemptions being detailed and protected.<sup>261</sup>

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<sup>253</sup> Art. 12 of the CCCTB Directive.

<sup>254</sup> Arts. 32 to 42 of the CCCTB Directive.

<sup>255</sup> Art. 43 of the CCCTB Directive.

<sup>256</sup> Art. 9 of the CCCTB Directive.

<sup>257</sup> Art. 9(1) of the CCCTB Directive.

<sup>258</sup> European Commission, ‘CCCTB: Possible Elements of a Technical Outline’ (CCCTB/WP057/doc/en, 26 July 2007), p.7.

<sup>259</sup> European Commission, ‘Taxable Income’ (07 September 2005, CCCTB/WP\017\doc/en), p.3.

<sup>260</sup> The preamble to the CCCTB Directive clause 10.

<sup>261</sup> For full discussion of the determination of taxable income under the CCCTB Directive see Christoph Spengel and York Zöllkau (Eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income: An International Comparison* (Springer 2012).

## 2.5.2 Consolidation

The second major phase of the CCCTB application is the consolidation of the individual tax bases of the group members.<sup>262</sup> Consolidation would remove most of the obstacles facing the companies operating in the EU. The problems resulting from transfer-pricing formalities and intra-group double taxation are abolished along with the high compliance cost. Furthermore, intra- group transactions are removed due to the use of consolidation.<sup>263</sup> In addition, withholding taxes and source taxation will not exist anymore between the members of a group.<sup>264</sup> In contrast, under existing tax systems, a group of companies operating in more than one Member State are compelled to present a separate tax declaration in each Member State, and by this declaration the profits created in the respective Member State are reported according to the domestic rules for the determination of taxable income. In contrast, consolidation will result in adding up the group's EU-wide profits and losses with one tax declaration of EU-wide group taxable income.<sup>265</sup>

The consolidation process raises several issues, as it involves the aggregation of the group members' income. It is necessary to identify the taxable entity which is subject to the consolidation mechanism; in other words, the taxable unit has to be defined, including qualifying subsidiaries and permanent establishments. There are some issues related to the definition of the taxable unit, such as the method of consolidation and the contours of the consolidated group. The consolidated consequences should also be addressed, including the elimination of withholding taxes; intra-group loss relief; and intra-group transactions treatment, but first the relationship between consolidation and IFRS accounting should be highlighted.

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<sup>262</sup> Christoph Spengel, 'Concept and Necessity of a Common Tax Base – an Academic Introduction' in Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.35.

<sup>263</sup> Art.59 of the CCCTB Directive.

<sup>264</sup> Art.60 of the CCCTB Directive.

<sup>265</sup> Clemens Fuest, 'The European Commission 's Proposal for a Common Consolidated Tax Base' ,Oxford Review of Economic Policy, Vol. 24,issue 4,2008 ,pp. 720-739, at 225.

### 2.5.2.1 Consolidation and IFRS

Consolidation in the context of IFRS accounting has been applicable to European listed companies since 2005.<sup>266</sup> The possibility of using consolidated IFRS accounts (which are prepared in accordance with IAS 27) for the consolidation of the CCCTB has been considered.<sup>267</sup> However, this approach to consolidation is not supported, for several reasons. Firstly, the accounting consolidated group is defined in a different way than it should be for tax purposes:<sup>268</sup> under the IFRS, an entity can be consolidated when another company holds a certain percentage of its capital, such as 50% of the affiliate's capital or practises control over that entity. Whereas in the consolidation for tax purposes the conditions of consolidation are stricter, this means that there would be an overlap between tax consolidation and financial consolidation, meaning that some companies will not be eligible for tax consolidation even if they are eligible for accounting consolidation. Secondly, accounting consolidation encompasses the whole group, even non-EU subsidiaries. Therefore, using the financial accounting is not possible without making adjustments in order to include some companies and to exclude others. However, adjusting the IFRS-group statement would be complex and would not alleviate the compliance cost. Another reason is that non-controlling or minority interests are treated differently for tax purposes than for financial accounting. Furthermore, this approach is not compatible with the Member States' tax practices.<sup>269</sup> Hence, consolidated IFRS-accounts cannot validly be used as a starting point for the CCCTB consolidation. Accordingly, the European Commission<sup>270</sup> has preferred the use of a tax-specific method of consolidation using the individual accounts, and this approach is consistent with Member States' practice with regard to the consolidated taxation of domestic groups.<sup>271</sup>

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<sup>266</sup> Kevin D'hooge, 'The Common Consolidated Corporate tax base: How does the new European Tax Policy alter Foreign Direct Investments?' Universiteit Gent, 2009, p.19.

<sup>267</sup> European Commission, 'The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax base for Companies' EU-Wide activities' (2003) Consultation Document; European Commission, 'An Internal Market without Tax Obstacles: Achievements and ongoing Initiatives and Remaining Challenges (Communication) COM(2003) 726, p.20.

<sup>268</sup> European Commission, COM (2003) 726, p.20.

<sup>269</sup> European Commission, 'Issues Related to Group Taxation, (5 May 2006, CCCTB\WP\035\doc\en), p.3.

<sup>270</sup> European Commission, 'The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax base for Companies' EU-Wide activities' (2003) Consultation Document, p.21.

<sup>271</sup> European Commission, COM (2003) 726, p.21.

### 2.5.2.2 The consolidated tax base (group notion)

The consolidated tax base is the total amount of a multi-jurisdictional *group* income.<sup>272</sup> The concept of a *group* is relevant for determining the qualifying companies that will automatically apply the CCCTB system once an election is made and for determining which companies have to consolidate their results. The definition of *group* is the same for both purposes.<sup>273</sup>

Since the business profitability of related companies is higher than that of independent ones by reason of their economic integration, the related entities in the Internal Market should be treated as a single unit for tax purposes. The assessment of the relationship between the related companies has to be based on some criteria in order to verify that each member of the group of companies, which benefits from the economic integration of the group, is really connected to that group.<sup>274</sup>

#### 2.5.2.2.1 Group definition

There are two main approaches to define a consolidated group: the legal definition and the definition based on economic criteria.<sup>275</sup> Whatever criteria are used to define the taxable unit, the aims of the CCCTB project have to be taken into consideration.<sup>276</sup> Under the economic approach, which follows the principle of the unitary business,<sup>277</sup> related entities can form a consolidated group when they are commonly controlled directly or indirectly by a parent company and have a relationship reflected in a sufficient economic integration. The economic integration between the related parties can be measured by various factors such as the significant number of transactions between the related parties, and when the group of companies are centrally

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<sup>272</sup> Art.57 of the CCCTB Directive.

<sup>273</sup> For more discussion on the group definition see Jakob Bundagaard and Niels Winther, 'The Concept of a Group for Common Consolidated Corporate Tax Base Purposes' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008), pp.137-156.

<sup>274</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.13.

<sup>275</sup> For a good analysis of defining a group in the CCCTB context see Antonio Russo, 'Formulary Apportionment for Europe: An Analysis and A Proposal', *Intertax*, Vol.33, No. 1, 2005, p.6.

<sup>276</sup> Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.31.

<sup>277</sup> Martens Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (New York 2006), p. 71.



administrated. The economic test seems to be consistent with the concept of the CCCTB, as it is based on the consolidation of income of entities which are economically integrated.<sup>278</sup>

However, by virtue of the subjective nature of the economic criteria in defining the consolidated group, several problems are raised. Firstly, with respect to tax administration, this approach entails a compliance cost for both taxpayers and tax authorities, and it does not achieve legal certainty. Hence, due to the lack of measures of economic integration between the group members, economic criteria are less feasible, as they are subjective. Moreover, experience from the US reveals the existence of several problems that accompany defining the consolidated group according to the economic approach.<sup>279</sup> Therefore, the adoption of economic criteria for defining the taxable unit in the CCCTB is not workable.

The definition of a consolidated group should be based on legal criteria which point out the mutuality of the relationship between the related parties. In other words, the test of consolidation should rely on a control test and tests which examine the existence of the economic interdependencies and a flow of value in the relationship between the related entities. These criteria should be easy to manage and not arbitrary.<sup>280</sup>

The legal criteria for defining the taxable unit are based on a legal ownership threshold. Namely, the legal definition is based on the legal ownership concept, which requires the ability to govern and control consolidated business activities in order to gain economic benefits. The legal definition relies on legal ownership, which refers to voting stock or equity: since voting power represents control, ownership of voting rights appears to be more suitable than ownership of capital.<sup>281</sup>

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<sup>278</sup> European Commission, 'The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax base for Companies' EU-Wide activities' (2003) Consultation Document, pp.10-13.

<sup>279</sup> Hellerstein, 'The European Commission's Report on Company Income Taxation: What the EU can Learn from the Experience of US States', *International Tax and Public Finance*, Vol. 11, 2004, p.206.

<sup>280</sup> *Ibid.*, p.205.

<sup>281</sup> European Commission, 'An overview of the Main Issues that Emerged at the third meeting of the sub group on group taxation, Working Document, CCCTB\WP\053\doc\en, 2007, pp.3-4.

The ownership threshold should be low, as the drawbacks of setting a high threshold (for instance, 100%) is that the higher the threshold, the more affiliates would fall outside the taxable group, and there would be a scope for tax planning through transactions with those controlled but non-consolidated companies in the new system. Accordingly an ownership threshold of 50% or 75% seems appropriate for defining the taxable unit under the CCCTB.<sup>282</sup>

The main advantages of the legal approach appear to lie firstly, in its simplicity from an administrative point of view for both taxpayers and administrations. It also provides the taxpayer with the greatest certainty in terms of the entities to be included or excluded. Moreover, in practice it is internationally recognised,<sup>283</sup> especially in the Member States of the EU in the context of domestic group taxation.<sup>284</sup> In contrast, the legal definition does not reflect the precise reality of the economic relationship between the members of consolidated group.<sup>285</sup> Accordingly, if the legal ownership criterion is manipulated, especially in the context of the CCCTB, it will result in a misdistribution of income; for example, a subsidiary can be consolidated in a group on the basis of the legal test and in fact it is economically independent. Then when the formula apportionment is applied it will have its share of the consolidated tax base, which would not have been apportioned to that subsidiary if the economic criteria were followed. Overall, although the legal criterion has many advantages, it is prone to tax manipulation with regard to the ownership interests.<sup>286</sup> Thus, the adoption of this test in the CCCTB would need to be accompanied by some anti-tax abuse provisions.<sup>287</sup>

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<sup>282</sup> European Commission, 'The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax base for Companies' EU-Wide activities' (2003) Consultation Document, pp.10-13.

<sup>283</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.15.

<sup>284</sup> Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.12.

<sup>285</sup> Martens Weiner, 'The European Union and Formula Apportionment: Caveat Emptor', *European Taxation*, 2001, p. 383.

<sup>286</sup> Joan M. Weiner, 'Would Introducing Formula Apportionment in the European Union Be a Dream Come True or the EU's worst Nightmare?', *Info Studien*, Vol.48, No.4,2002,pp.519-532 at 528.

<sup>287</sup> Hellerstein, 'The European Commission's Report on Company Income Taxation: What the EU can Learn from the Experience of US States', *International Tax and Public Finance*, Vol. 11, 2004, p.205.

### 2.5.2.2.2 Qualifying Subsidiaries

The basic idea is that a *group* consists of the company opting to apply the CCCTB and all its *qualifying subsidiaries*; namely, the all-in or all out principle.<sup>288</sup> Based on the above debate on the criteria for the group definition, it can be suggested that the legal definition should be adopted in the context of the CCCTB. Under the CCCTB proposed Directive, the legal approach is approved; based on the concept of the legal definition, permanent establishments located in the EU will be qualified for consolidation as they are not legally independent from their respective CCCTB-parent company.<sup>289</sup> However, as regards subsidiaries, their legal independence exists based on the majority of the voting rights or capital ownership,<sup>290</sup> therefore, the CCCTB proposal sets the conditions on which a *subsidiary qualifies* for consolidation.

Under the CCCTB Directive, a subsidiary will be included in the consolidation when more than 50% of its voting rights are owned directly or indirectly by the parent company, and when the parent company owns more than 75% of its capital<sup>291</sup> or owns 75% of the rights giving entitlement to profits.<sup>292</sup> It should be noticed that the ownership rights criterion is an alternative to the profit entitlement criterion. A company will be a *qualifying subsidiary* provided that one of these tests is satisfied as well as the voting control test. Thus the legal definition is established by reference to equity ownership and voting stocks. The adoption of the dual requirement for consolidation is preferable to only reference to voting stock, as the voting rights threshold satisfies the principle of control for the consolidation purpose, and the capital ownership ensures the required economic integration between the members of the consolidated group.<sup>293</sup>

Regarding the threshold set for consolidation, the simple majority test of more than 50% or 75% is supported, as it reflects the idea of having a control, and it is consistent with the objective of the CCCTB which is not to alter the position of the individual members

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<sup>288</sup> Art.54 of the CCCTB Directive.

<sup>289</sup> Art.55 (a) of the CCCTB Directive.

<sup>290</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline' (26 July 2007, CCCTB/WP057/doc/en), p.22.

<sup>291</sup> This is in line with the Parent /Subsidiary Directive, Council Directive (EEC) 90/435 23 July 1990.

<sup>292</sup> Art. 54(1) of the CCCTB Directive.

<sup>293</sup> Claus Staringer, 'Requirements for Forming a Group', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), pp.132-135; European Commission, COM(2003)726 final,p.22.

of the group as a taxable entity, but only to modify the tax base.<sup>294</sup> However, the low threshold established for consolidation will affect the position of the minority shareholder, hence special provisions for their protection are required.<sup>295</sup>

When the ownership and the voting rights threshold are met, then the entity is eligible for consolidation. This implies that the consolidated group will include entities owned by less than 100% of capital. The question raised is whether the entire income of such entities should be consolidated or only the share of income corresponding to the respective percentage of the ownership.<sup>296</sup>

*In theory*, the pro rata solution seems justified, on the basis that only profits or losses equal to the owned percentage belong to the group.<sup>297</sup> However, since the economies of scale of integrated entities result in higher profits for such a group of entities than the profits earned when they are operating independently, the application of the pro rata approach in the context of the CCCTB would be subjective and not accurate in terms of the amount of profit or loss to be allocated to the group members. *In practice*, the pro rata solution would be problematic when calculating the non-consolidated part of the income, as it has to be computed according to traditional arm's length price, meaning that the same entity will be treated by two different approaches, formulary apportionment and arm's length. This would be cumbersome and costly, and would in turn infringe the main advantage of the CCCTB which would be the full offsetting of intra-group transactions. Hence the pro rata approach is subjective and difficult to apply in practice.<sup>298</sup>

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<sup>294</sup> Claus Staringer, 'Requirements for forming a group', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), p.134.

<sup>295</sup> Jakob Bundagaard and Niels Winther, 'The Concept of a Group for Common Consolidated Corporate Tax Base Purposes' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds) *Common Consolidated Corporate Tax Base* (Linde 2008), pp.149-150.

<sup>296</sup> Caresten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union*, (Gabler 2009), p.171.

<sup>297</sup> Hellerstein Jerome R., and Walter Hellerstein, *State Taxation* (Warren, Gorham & Lamont; 3rd edition: 1998), p.205.

<sup>298</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.16.

However, the full inclusion of an affiliate's total income is preferable to proportional consolidation,<sup>299</sup> because it is simple to apply and more compatible with the concept of consolidation. In other words, it is relatively less complex to apply than the pro rata approach.<sup>300</sup> Except for the issue of the trade-off between the minority and majority shareholders' interests, this issue should be solved through company law.<sup>301</sup> From the tax perspective, it seems that there is no need for compensation of minority shareholders under the CCCTB as all the group members receive reciprocal advantages and disadvantages.<sup>302</sup>

Under the CCCTB Directive the full consolidation approach is approved.<sup>303</sup> Accordingly, for the purpose of consolidation, when the required threshold of voting stock is met with regard to immediate subsidiaries and sub-subsidiaries, the parent company will be considered to have 100% of the voting rights.<sup>304</sup> This indicates that the voting rights ensures the full control over the subsidiary, but when a direct or indirect holding is less than 50%, it would count as zero.<sup>305</sup>

As regards the calculation of the ownership percentage, the multiplication principle is followed in the CCCTB Directive. When calculating the indirect holding, the threshold of ownership of capital in the intermediate subsidiaries must be multiplied by each tier of the respective holding.<sup>306</sup> However there is an exception for the direct or indirect holding of 75% or less of ownership rights: it will be considered in the calculation of the threshold percentage including the rights in companies resident in third countries.<sup>307</sup>

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<sup>299</sup> European Commission, 'Progress to Date and Future plans for the CCCTB' (20 November 2006, CCCTB/WP\046\doc\en,p.12.

<sup>300</sup> Charles E. McLure, JR and Walter Hellerstein, 'The European Commission's Report on Company Income Taxation: What the EU can Learn from the Experience of US States', International Tax and Public Finance, Vol. 11, 2004, p.205.

<sup>301</sup> European Commission, 'Progress to Date and Future plans for the CCCTB' (20 November 2006, CCCTB/WP\046\doc\en,p.12.

<sup>302</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline', CCCTB/WP057/doc/en, p.22.

<sup>303</sup> Art.57 of the CCCTB Directive.

<sup>304</sup> Art. 54(2) (a) of the CCCTB Directive.

<sup>305</sup> European Commission, 'Eligibility Tests for Companies and the Definition of a CCCTB Group' (30 August 2010 Taxud D1, CCCTB/RD\001\doc\en) p.4.

<sup>306</sup> For example see CCCTB: Possible Elements of a Technical Outline' (CCCTB/WP057/doc/en,) p.22

<sup>307</sup> Art. 54(2) (b) of the CCCTB directive.

### 2.5.2.2.3 The group's construction

The CCCTB Directive defines a group broadly by reference to the company that heads the chain of companies making up the group, together with its qualifying subsidiaries.<sup>308</sup> The Directive states that the head company can be either a resident taxpayer or a non-resident taxpayer.<sup>309</sup> A taxpayer (whether resident or non-resident) is defined as a company which has opted to apply the CCCTB system.<sup>310</sup> Thus, a company that has not so opted cannot be the head of a CCCTB group. The concept of a qualifying subsidiary, as described above, is central to the definition of a group for CCCTB purposes and accordingly for which companies have to apply the system. The concept of a permanent establishment<sup>311</sup> performs a similar function.

The company qualifying for consolidation as defined above will form a group with other entities in the EU. The construction of group units eligible for consolidation should be determined. The various main forms of a group construction would be as follows: a company resident in Member State of the EU will form a group with all its permanent Establishments and/or all its eligible subsidiaries resident in one or more Member States. In addition, a group will comprise a resident taxpayer with its EU-located permanent establishments of its qualifying subsidiaries which are resident in a third country. Another form of group will cover a resident taxpayer with other resident taxpayers which are qualifying subsidiaries of the same company which is resident in a third country and eligible to opt for the CCCTB system.<sup>312</sup>

Moreover, permanent establishments located in Member States and controlled by a parent company resident in a third country would form a group with all its qualifying subsidiaries resident in one or more Member States including the permanent establishments of the latter located in EU-Member States.<sup>313</sup>

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<sup>308</sup> The CCCTB Directive does not define which company should be the head of the group. However, it provides for the definition of the principal taxpayer which is different than the group head. See Art.4 (6) of the CCCTB Directive.

<sup>309</sup> Art.55 of the CCCTB Directive.

<sup>310</sup> Art.4 (2) of the CCCTB Directive.

<sup>311</sup> Art.5 of the CCCTB Directive.

<sup>312</sup> Art. 55 of the CCCTB Directive.

<sup>313</sup> Art. 55 of the CCCTB Directive.

Overall, permanent establishments and subsidiaries located in one or more Member States whether owned-directly or indirectly can form a group in very different settings with their parent company as long as the eligibility test (voting rights and capital or profit) is met. On the other hand, a third-country company, either as a taxpayer through the EU-located permanent establishments or as mutual entity in the shareholding chain, will not fragment the group's structure.<sup>314</sup> (The group structure when a third country is involved will be examined in detail in the next chapter). The consolidation is mandatory for all qualifying subsidiaries and permanent establishments of a parent company who opted for the CCCTB; namely, the principle of 'all-in or all-out' applies.<sup>315</sup>

### **2.5.2.3 The consolidation consequences**

#### **2.5.2.3.1 Elimination of intra group transactions and loss relief**

When the group eligible for consolidation is identified (as discussed above), the tax bases of the group's members are consolidated.<sup>316</sup> Normally, the individual companies within the group perform trade transactions on the disposal of stocks, shares, fixed assets or other tangible or intangible assets which result in profits or losses.<sup>317</sup> These profits and losses are included in the tax base of the respective group member on an accrual basis.<sup>318</sup> However, in the process of consolidation (calculating the consolidated tax base), profits and losses arising from direct intra-group transactions are ignored, but for this purpose two conditions have to be met. Firstly, the respective profits and losses have to accrue at the time when the intra-group transaction is carried out. Secondly, the parties involved in such a transaction have to be group members at that time.<sup>319</sup>

There are some methods through which the intra-group transaction can be eliminated.<sup>320</sup> According to the method provided in the CCCTB, each group member computes its tax base in the traditional manner; namely, separate accounting, but in accordance with the CCCTB rules. Profits and losses realised on the transfers between the group members

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<sup>314</sup> European Commission, 'Eligibility Tests for Companies and the Definition of a CCCTB Group' (30 August 2010 Taxud D1, CCCTB/RD\001\doc\en) p.3.

<sup>315</sup> European Commission, 'Possible Elements of a Technical Outline' (CCCTB/WP057/doc/en)p.23.

<sup>316</sup> Art. 57 of the CCCTB Directive.

<sup>317</sup> *Ibid*, p.28.

<sup>318</sup> Art 9(1) of the CCCTB Directive.

<sup>319</sup> Art 59(1)(2) of the CCCTB Directive

<sup>320</sup> European Commission, 'Issues Related to Group Taxation' (5 May 2006, CCCTB\WP\035\doc\en) p.8; Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.37.

are taken into account and recorded at cost, and the groups will provide an adequate and consistent method for recording intra-group transfers and sales at the lower cost and value. This method can be changed at the beginning of a tax year only for commercial purposes.<sup>321</sup> Then when calculating the consolidated tax base, the profits and losses arising from intra-group transactions will be ignored and deferred for taxation until the consolidated tax base is apportioned. Therefore, there will be no need for adjusting transfer prices for tax purposes.<sup>322</sup> The underlying concept is that of consolidation, where the consolidated group of companies is treated as a single economic unit for tax purposes, thus intra-group profits or losses cannot be made.<sup>323</sup> The approach adopted by the CCCTB for disregarding the intra-group transactions preserves an audit trail, which would be beneficial when the formation of the consolidated group changes and intra-group income has to be recaptured.<sup>324</sup>

#### **2.5.2.3.2 Withholding taxes**

Another major benefit of consolidation is the abolition of withholding and source taxation within the consolidated group.<sup>325</sup> Intra-group payments such as dividends, interests and royalties as taxable events will be disregarded. Therefore, consolidation contributes to the avoidance of double taxation income which result from tax rights conflicts between Member States in respect to such payments. Moreover, restrictions on the deductibility of business expenses such as disallowance of interest deduction will not apply within the consolidated group.<sup>326</sup>

#### **2.5.2.3.3 Consolidated profits and losses**

Another major corporate tax-related obstacle in the EU, which is loss relief, is removed via the final stage of consolidation. The individual tax bases of the group members are consolidated; namely, added together, and losses made by one group member are

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<sup>321</sup> Art.59 (3) of the CCCTB Directive; for more on the technical issues regarding consolidation Methods see Andreas Oestreicher, 'CCCTB-Methods of Consolidation' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), pp.517-546.

<sup>322</sup> Art 59 (4) of the CCCTB Directive

<sup>323</sup> European Commission, Possible Elements of a Technical Outline, CCCTB/WP057/doc/en, p.28.

<sup>324</sup> Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.37.

<sup>325</sup> For discussion of the consolidation process and benefits see Paul H.M. Simonis, 'CCCTB: Some Observations on Consolidation from a Dutch Perspective', *Intertax*, Vo. 37, Issue 1, 2009, pp.19-39.

<sup>326</sup> Art. 60 of the CCCTB Directive.



automatically offset against profits of other group units, which would result in net taxation income at the EU level.<sup>327</sup> If the consolidated tax base is negative, the loss is carried forward at the level of the group and offset against the profits of the next consolidated tax base. In contrast, when the group is profitable its consolidated tax base is shared between the members of the group according to the formulary apportionment.<sup>328</sup> The consolidation mechanism effectively overrides the provision for unlimited carry-forward by the taxpayer incurring the loss.<sup>329</sup> However, it does not affect the treatment of pre-group losses.<sup>330</sup>

In this context, tax consolidation<sup>331</sup> means the aggregation of all individual pre-tax results of group entities with the neutralisation of all intra-group transaction including loss and profit offset. Thereby, the consolidated tax base is the overall net result of the group. In this way, the CCCTB is considered as a genuine tax consolidation within the framework of one single tax base, not just cross-border loss compensation.<sup>332</sup>

The above approach adopted by the CCCTB to carry loss forward at the *group level* ensures that loss is not stranded in one Member State. The possibility of tax planning through the relocating apportionment factors in order to allocate a group's losses to those Member States with high tax rates does not exist because the offset of the negative consolidated tax base does not depend on the apportionment mechanism; it is not shared through formulary apportionment.

However, this approach has some drawbacks. Firstly, it results in a lopsided treatment of profits and losses: whereas a positive group income is apportioned by means of formulary apportionment, a negative consolidated tax base is carried forward at the group level and decreases future profits.<sup>333</sup> Furthermore, this approach may cause

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<sup>327</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2008), p.172.

<sup>328</sup> Art.57 of the CCCTB Directive.

<sup>329</sup> Art.43 of the CCCTB Directive.

<sup>330</sup> Art.64 of the CCCTB Directive.

<sup>331</sup> Consolidation in its original meaning is used in accounting for the aggregation of the individual financial statements of all group members with elimination of all intra-group transaction affecting the profits and loss accounts.

<sup>332</sup> European Commission, 'Issues Related to Group Taxation' (5 May 2006, CCCTB\WP\035\doc\en) p.4.

<sup>333</sup> Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.36.

problems in respect to income earned from third countries, especially where a group member applies the credit method to relieve double taxation in relation to foreign income. In this case, if the consolidated tax base is negative and not apportioned the group member that is paid the credit will bear a high tax burden as the loss relief will not be active at the level of the receiving company. Loss relief is only available at the group level in consequent years.<sup>334</sup>

According to the second approach, which was considered by the European Commission, the consolidated loss is allocated to each respective Member State according to the formulary apportionment, then the share of loss is offset against the share of the positive consolidated tax base in future years.<sup>335</sup> It is submitted that this approach is in line with the underlying idea of consolidation and formulary apportionment. Besides, it treats profits and losses in a symmetrical way. In other words, both the negative and positive consolidated tax base is apportioned among the respective group members. Consequently, each group member would have its share of the losses in the period in which they are offset at the group level. It is also expected that companies can utilize losses more than once, thus losses may not only offset the group level, but can also be carried backwards or forwards in preceding or following years so as to be offset against profits in the separate account of the group member concerned.<sup>336</sup> Therefore, special rules to avoid the so-called “double-dip” are required. For this it is suggested that any carry-over of losses at the company level ‘should be added back to the consolidated tax base at the group level, or the separate taxable income before compensation for loss carry forwards of each group member enters the consolidation.’<sup>337</sup> Thus where the losses are offset through the consolidation process, it would not be used again at the company level.<sup>338</sup> It is submitted that the CCCTB Directive should adopt the second approach as it has more advantages than the first one, which is stated in the CCCTB Directive.

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<sup>334</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2008), p.173.

<sup>335</sup> European Commission, Progress to Date and Future Plans for the CCCTB’ (20 November 2006, CCCTB/WP/046/doc/en), p.12.

<sup>336</sup> Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.36.

<sup>337</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler, 2008), p.174.

<sup>338</sup> *Ibid.*

## 2.6 Formulary apportionment

### 2.6.1 The sharing mechanism

A further key element in the CCCTB project is a sharing mechanism for distributing the consolidated tax base to the group entities resident in various Member States. In other words, after determining the consolidated tax base, it will be distributed to the participating Member States according to an agreed sharing mechanism.<sup>339</sup> Consequently, Member States can apply their tax rates to their apportioned share of the consolidated tax base.<sup>340</sup> The underlying idea of the sharing mechanism is to ensure that the consolidated tax base is apportioned to all Member States that have had a share in generating the consolidated profits. This would be verified through the apportionment factors, which are related to the economic activities of multinationals in different jurisdictions; that is to say, the formula factors constitute the economic presence of companies in a given country and companies would pay taxes in proportion to their economic presence; namely, source-based taxation.<sup>341</sup>

The sharing mechanism is not an objective by itself for achieving a comprehensive tax reform, but it is an inevitable consequence for consolidation.<sup>342</sup> The driving aim for selecting a sharing mechanism is application simplicity, in relation to both taxpayers and tax administration; it should not be manipulated by taxpayers. It also has to be fair and equitable when allocating the tax base between the entities concerned. Furthermore, it should avoid bringing reversed results with regard to tax competition.<sup>343</sup>

To achieve these objectives, the sharing mechanism should have a macro-based apportionment or value added (VA) approach.<sup>344</sup> The macro-based apportionment could be established by reference to factors that are aggregated at national level; that is to say, the consolidated tax base can be apportioned to the Member States concerned in relation

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<sup>339</sup> Art.86 of the CCCTB Directive.

<sup>340</sup> Art.103 of the CCCTB Directive.

<sup>341</sup> Clemens Fuest, 'The European Commission's proposal for a common consolidated corporate tax base', *Oxford Review of Economic Policy*, Vol. 24, No.4, 2008, p.724.

<sup>342</sup> European Commission, 'Possible elements of the Sharing Mechanism' (13 November 2007, CCCTB/WP060\doc\en) p.5.

<sup>343</sup> *Ibid.*

<sup>344</sup> Peter Birch Sorensen, 'Company Tax Reform in the European Union', *International Tax and Public Finance*, Vol.11, 2004, p.95.

to their GDP or national VAT bases. This approach would be cost efficient, as well as simple and easy for companies and tax administrations to manage. It would prevent any tax manipulation by companies, and eliminate tax planning as the possibility of the relocation of the group's economic activities would be avoided.<sup>345</sup>

However, the main downsides of this approach are that it does not reflect the real connection between the economic activities and the tax liability in the relevant Member State. Moreover, in the event that all Member States participate in the CCCTB, this method would lead to a race-to-the-top of the tax rate within the Member States as they would all have a fixed share in any participating group. To solve this problem, tax rates at the EU level should be harmonised. The macro-based approach is simple but it is not fair, hence it does not seem to be realistic for the apportionment of the consolidated tax base in the CCCTB project.<sup>346</sup>

Alternatively, the Value Added (VA) approach has been proposed.<sup>347</sup> This is acceptable from a conceptual point of view and there is considerable experience of VAT area in the EU. In other words, companies and tax administrations are familiar with the notion of VA. Since this is a micro-based method, it maintains the connection between the economic activities of a given company in a certain country and the tax liability of that company in the country concerned. This would lead to a fair outcome of apportionment under the VA.<sup>348</sup>

However, the VA would be a complex approach to apply for companies as it requires a great deal of computation, especially when the VA is based on the VAT returns. This would contradict the main purpose of the CCCTB which is simplicity and compliance cost reduction. Moreover, the VA approach is prone to manipulation. Additionally, according to this approach the intra-group transactions have to be valued, this evaluation would be done at arm's length principle and transfer pricing would be used. Transfer pricing problems would come to the surface, though the manipulation of

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<sup>345</sup> European Commission, 'An Overview of the Main Issues that Emerged During the Discussion on the Mechanism for Sharing the CCCTB' (27 February 2007, CCCTB\WP\052\doc\en),p.3.

<sup>346</sup> European Commission, (27 February 2007, CCCTB\WP\052\doc\en),p.3.

<sup>347</sup> European Commission, 'The Design of an Apportionment Mechanism for an EU Consolidated Tax Base' (DOC (04) 1404, 13 February 2004), p.20.

<sup>348</sup> European Commission, 'Comments on Document CCCTB\WP\047, 2006-Sharing Mechanism- 2007-03-12, p.2.

transfer pricing with the VA measure is narrower than with the current transfer pricing. However, the CCCTB with consolidation is designed to eliminate entirely the problems of transfer pricing.<sup>349</sup> Therefore the VA approach is not appropriate for the allocation of a consolidated tax base in the CCCTB.

## 2.6.2 Arm's length under separate accounting

Generally, Separate Accounting (SA) under the arm's length principle is the prevailing approach for allocating profits between the Member States in the EU, and it has a long history not only in Europe but around the world.<sup>350</sup> The international community adopted the separate accounting approach in the early 20<sup>th</sup> century as the approved technique to determine the amount of income that a multinational enterprise earned in each country.<sup>351</sup>

In the EU, as a result of cross-border business activities through affiliated companies, for tax purposes each affiliate must calculate its tax base individually at arm's length as if it was independent. This means that the legal status of the affiliates is considered. Then the affiliate's income is reported and taxed separately according to the tax rules of the Member States in which it operates. Thus, the separate entity approach applies and the transfer prices of transactions between the related entities are established according to the arm's length principle.<sup>352</sup>

The basic concept underlying the arm's length principle is that the transactions between related entities which are located in different jurisdictions have to be priced in the same manner as between independent enterprises in the market;<sup>353</sup> that is to say, the market price is the benchmark for the profit allocation.<sup>354</sup>

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<sup>349</sup> European Commission, 'Comments on Document CCCTB\WP\047, 2006-Sharing Mechanism- 2007-03-12, p.2.

<sup>350</sup> Jens Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010), p.32.

<sup>351</sup> Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.3.

<sup>352</sup> Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.3.

<sup>353</sup> Charles E. McLure Jr., 'Defining a Unitary Business: An Economist's View' (1984), National Bureau of Economic Research Working Paper Series W1125, Stanford, p.105.

<sup>354</sup> Jens Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010), p.291.

The separate accounting approach can be justified by some reasons. Firstly, the appeal of the concept from a theoretical standpoint is that associated and independent enterprises are treated equally.<sup>355</sup> Moreover, for the same reason the OECD member states apply the arm's length principle, since it provides broad parity of tax treatment for multinational enterprises and independent enterprises. Accordingly, it eliminates any tax rewards or disadvantages that result only because of the structural form of the enterprise. Separate accounting under the arm's length concept is also defended on the basis of its worldwide acceptance, not only in the national practice of countries, but also in the Model Tax Convention and bilateral tax treaties. For example, this principle is contained in Article 9 (Associated Enterprises) and in Article 7 (Business Profits) of the OECD Model.<sup>356</sup>

However, at the EU level there are good reasons for substituting the separate accounting approach for formulary apportionment. It can be rejected on the basis that the EU has become an economically integrated area.<sup>357</sup> This implies that multinational enterprises operating within the EU are in fact economically integrated, but these affiliated companies are treated as separate entities solely for Member States' tax purposes.<sup>358</sup>

The separate accounting method is also criticised on the grounds that economic efficiency is higher between economically integrated parties, which in turn results in higher profit trade; that is to say, transactions between the members of an integrated group are more profitable than those of unrelated entities. Thus, comparing controlled transactions with uncontrolled transactions pursuant to the arm's length principle is systemically inapplicable.<sup>359</sup> Furthermore, the comparability of transactions between controlled and uncontrolled parties, which the arm's length principle implies, is difficult

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<sup>355</sup> Gammie 'Arm's length or Formulary Apportionment' in Brian J. Arnold, Jacques Sasseville, Eric M. Zolt, (Eds.) *The Taxation of Business Profits Under Tax Treaties*(Canadian Tax Foundation 2003),p.209.

<sup>356</sup> Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.4.

<sup>357</sup> Nellie Munin, 'Tax in Troubled Time: Is It the Time for A Common Corporate Tax Base in the EU?', *EC Tax Review*, 2011, pp.121-133 at 128

<sup>358</sup> Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.4.

<sup>359</sup> Charles E. McLure Jr., 'Defining a Unitary Business: An Economist's View' (1984), National Bureau of Economic Research Working Paper Series W1125, Stanford, p.105.

to find, and entails a huge compliance cost.<sup>360</sup> The dissipation of knowledge among multinational enterprises and the transactions involving knowledge-capital make it more difficult to identify transfer prices,<sup>361</sup> and the difficulty of comparability between related affiliates and independent parties compels governments to find comparable prices for the transactions or provide appropriate transfer prices. Consequently, companies are required to apply evidence for transfer arm's length basis which is a costly obligation both for taxpayers to comply with and for tax authorities to audit.<sup>362</sup>

Moreover, the OECD Transfer Pricing Guidelines are interpreted differently by each Member State, which leads to double taxation,<sup>363</sup> and at the international level double taxation puts cross-border investments in a disadvantageous position compared to domestic investments. Even the measures initiated by the EU, such as tax arbitration convention to solve double taxation caused by transfer pricing, suffer from shortcomings. Under this convention, the concerned parties have procedures and negotiations to solve the dispute within two years. Apparently, it is time consuming and the cost caused by double taxation is borne by companies during this time.<sup>363</sup>

Furthermore, there are difficulties in identifying the arm's length prices in respect to certain intra-group transactions, such as transactions involving intangible assets, and it is becoming even more difficult with the increased use of Information and Communication Technology (ICT).<sup>364</sup> Therefore, pricing intra-group transfers on the basis of separate accounting is becoming increasingly vulnerable to income shifting.<sup>365</sup>

To conclude, the arm's length principle ignores the essential differences between controlled and uncontrolled transactions. Besides, it is not consistent with the economic

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<sup>360</sup> European Commission, 'Company Taxation in the Internal Market' (Communication) COM (2001)582final, p.267.

<sup>361</sup> Carsten Wendt, 'A Common Consolidated Corporate Tax Base in the European Union' (Gabler 2008)p.89

<sup>362</sup> European Commission, 'Company Taxation in the Internal Market' (Communication) COM (2001)582final, p.263.

<sup>363</sup> *Ibid*, p.269.

<sup>364</sup> Anne Schafer, Christoph Spengel, Otto H. Jacobs, 'ICT and Profit Allocation within Multinational Group', *Intertax*, Vol.32, Issue 6/7, 2004, pp268-283, at 275.

<sup>365</sup> Peter Birch Sorensen, 'Company Tax Reform in the European Union', *International Tax and Public Finance*, Vol.11, 2004, p.94; for more on transfer pricing problems see Stefan Mayer, *Formulary Apportionment for the Internal Market*(IBFD 2009),p.51.

reality of integrated multinational firms, and shows deficits with respect to the criteria of equity, neutrality, and administrative aspects.

### 2.6.3 Formulary apportionment in the CCCTB

Due to the above-mentioned drawbacks of the arm's length principle, the application of Formulary Apportionment as a micro-based approach is preferred.<sup>366</sup> In principle, formulary apportionment would eliminate the need to determine transfer prices for the purpose of allocating the corporate tax base across jurisdictions. In a setting of growing economic integration, a switch from separate accounting to formulary apportionment seems increasingly attractive. It has been used to allocate the corporate tax base at the subnational level in closely integrated domestic markets of federal countries such as the United States, Canada, Germany and Switzerland.<sup>367</sup>

It is submitted that formulary apportionment is the most appropriate approach for sharing the consolidated tax base between group members in the EU.<sup>368</sup> However, the usage of this approach in the US and Canada for nearly a century shows that there are several problems that hinder its perfect implementation. This includes complexities due to the convergence of the factors and their definition and the group definition. Nevertheless, the experience of the US and Canada can form valuable guidance for the EU in designing the CCCTB-formulary apportionment and in its application at the practical level.<sup>369</sup>

The CCCTB Directive provides that the *consolidated tax base* shall be shared between the *group members* in each tax year on the basis of formula apportionment.<sup>370</sup> The concept of CCCTB-Formulary apportionment is that various entities of a consolidated

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<sup>366</sup> Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', Bulletin for International Taxation, May 2008, pp.201-215, at 203. For illustration on how the FA operates using EU data see Joan Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) pp.33-44.

<sup>367</sup> Peter Birch Sorensen, 'Company Tax Reform in the European Union', International Tax and Public Finance, Vol.11, 2004, p.94.

<sup>368</sup> Richard Miller Bird, Donald J. S. Brean, *The Interjurisdictional Allocation of Income and the Unitary Taxation Debate* (Economic Council of Canada, 1986), p.11.

<sup>369</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.44.

<sup>370</sup> Art. 86 of the CCCTB Directive.



group will have their shares of the group's total profits according to their participation in the income creation, which is measured by labour, assets, and sales factors.<sup>371</sup> This implies that the taxing rights in the EU will be established on the basis of source taxation. For fair and equitable apportionment, the formula is an unchanging one across the EU. The three factors mentioned are equally weighted, and they are the same within all of the Member States involved. Moreover, the formula is robust, meaning that because of the weight of a factor (three factors in one formula) shifting one factor only shifts the outcome with less than one.<sup>372</sup>

#### **2.6.4 Factors of formulary apportionment**

The formula contains micro-based apportioning factors which take into account both demand and supply sides (labour and assets represent supply whereas sales denotes demand). The basic rules on the determination and definition of each factor have to consider three parameters:<sup>373</sup> the scope, location and evaluation of each factor.

##### **2.6.4.1 Assets**

Capital is included in the formulary apportionment because it is a critical income-generating factor.<sup>374</sup> The *scope* of the capital factor consists of all tangible fixed assets including land, buildings, plant and machinery, other fixture and fitting tools and equipment.<sup>375</sup> In contrast, intangible assets including inventories are excluded from the assets factor. The main reason for this exclusion is the difficulty of evaluating intangible assets, especially with self-generated assets. Even if a solution is sought, uncertainties over their location will still arise. Intangible assets are very mobile and thus can be used as a tool for tax planning to transfer part of the assets factor from one Member State to another. However, as the intangible assets constitute an important income-generating element in the capital factor, to disregard them completely would lead to misdistribution

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<sup>371</sup> European Commission, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada' (2005) Working paper N 8/2005, p.9.

<sup>372</sup> European Commission, 'Possible elements of the Sharing Mechanism (13 November 2000, CCCTB/WP060\doc\en),p.10.

<sup>373</sup> For discussion on composition of the FA factors based on the experience of the US and Canada see Joan Martens-Weiner, (2006), pp.47-58; Peter Birch Sorensen(2004), p.94et seq

<sup>374</sup> European Commission, (CCCTBWG) 'An Overview if the Main Issues that emerged during the discussion on the Mechanism for Sharing the CCCTB' (27 February 2007, CCCTB\WP\052\doc\en), p.7.

<sup>375</sup> Art.92 (1) of the CCCTB Council Directive; European Commission, CCCTB/WP060\doc\en,p.9.

of the tax base.<sup>376</sup> This exclusion has been justified on the basis that this apportionment item is already included indirectly in the other factors, either labour or sales.<sup>377</sup> Therefore, it can be noticed that the CCCTB Directive provides that during the five years that follow an entity joining an existing group or a new group, the overall amount of costs incurred by the taxpayer for research, development, marketing and advertising over the six years that preceded its entry into the group will be included in the assets factor.<sup>378</sup>

With regard to the *location* of the assets, as a general rule all tangible fixed assets will be attributed to the group member that is the economic owner; namely, the entity that has the right to depreciate the assets and in the vast majority of cases is using them effectively. However, if the economic owner cannot be identified, the fixed assets are attributed to the legal owner of the capital factor.<sup>379</sup> If the economic owner is not using the assets effectively it will be included in the assets factor of the group member that effectively uses the assets. In this case, these assets have to represent more than 5% of the value of all fixed tangible assets of the group member that uses those assets effectively.<sup>380</sup>

The share of the consolidated tax base on the basis of the assets factor is *calculated* by comparing the value of the qualifying assets attributable to a group member with the value of the qualifying assets attributable to the entire group.<sup>381</sup> The *valuation* of assets such as land and other non-depreciable fixed tangible assets is valued at the book value. The written-down value is the closest value to the market value, but the latter method is not followed in the CCCTB due to its measuring difficulties.<sup>382</sup> Individually-depreciated and the pool of fixed assets are valued at the average of their value for tax purposes at the beginning and at the end of a tax year.<sup>383</sup>

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<sup>376</sup> European Commission, CCCTB/WP060\doc\en,p.10.

<sup>377</sup> European Commission, (CCCTBWG) ‘An Overview if the Main Issues that emerged during the discussion on the Mechanism for Sharing the CCCTB’ (27 February 2007, CCCTB\WP\052\doc\en),

<sup>378</sup> Art.92 (2) of the CCCTB Directive

<sup>379</sup> Art.93 (1) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.11.

<sup>380</sup> Art.93 (2) of the CCCTB Directive

<sup>381</sup> Art.92 (1) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.9.

<sup>382</sup> Art.94 (1) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.10.

<sup>383</sup> Art.94 (2) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.10.

### 2.6.4.2 Labour

Labour is an important factor in the income generation; therefore it is included in the formulary apportionment. The labour factor comprises two equally weighted elements: payroll and number of employees.<sup>384</sup> Since the costs of payroll vary significantly across the EU, using only the payroll element would result in an inappropriate distribution of the consolidated tax base. Therefore, the number of employees is used as well, to avoid the necessary adjustment to the payroll element.<sup>385</sup>

To *allocate* a share of the consolidated tax base to a group member on the basis of the labour factor, it is necessary to know the result of dividing the cost of the qualifying workforce and the number of employees (each element is considered as one half) attributable to that group member by the payroll and the number of employees of the entire group.<sup>386</sup>

Payroll is measured by the cost of wages, salaries and bonuses. It also covers all kinds of compensation paid to the employees including connected pension and social security costs paid by the employer.<sup>387</sup> The number of employees is calculated at the end of the tax year.<sup>388</sup> The definition of 'employee' is based on the national legislation of the Member State where the work is performed. However, it is suggested that the scope of the work force should be widened to include managers and directors.<sup>389</sup>

With regard to the *calculation* of payroll costs, it is valued at the amount of remuneration, which is considered as deductible expenses by the employer for the purpose of computing the tax base in the tax year.<sup>390</sup> With regard to the *location* of the labour factor, employees are included in the labour factor of the group member from which they receive remuneration.<sup>391</sup> However, as an exception, outsourced employees from another group member will be included the factor of the receiving group member

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<sup>384</sup> Art.90 (1) of the CCCTB Directive

<sup>385</sup> European Commission, (27 February 2007, CCCTB\WP\052\doc\en),p.9.

<sup>386</sup> Art.90 (1) of the CCCTB Directive.

<sup>387</sup> Art.91 (4) of the CCCTB Directive.

<sup>388</sup> Art.90 (2) of the CCCTB Directive.

<sup>389</sup> Art.90 (3) of the CCCTB Directive.

<sup>390</sup> Art.91 (5) of the CCCTB Directive.

<sup>391</sup> Art.91 (1) of the CCCTB Directive.

as long as they perform the same activities that would normally be carried out by the employees of the latter group member.<sup>392</sup>

However, in order to avoid factor shifting,<sup>393</sup> if the employees physically exercise their employment under the control and the responsibility of a group member other than the one from which they receive remuneration, the number of these employees and the amount of payroll relating to them will be included in the labour factor of the former group member. For this, two conditions are required: firstly, the employment has to last for an uninterrupted period of at least three months. Secondly, the number of employees should count for at least 5% of the total number of employees of the group member from which they receive the remuneration.<sup>394</sup>

### 2.6.4.3 Sales

Since companies make profits only insofar as their output is sold, sales are considered to be an imperative factor in the apportionment of the tax base.<sup>395</sup> Therefore, they are included in the formulary apportionment.<sup>396</sup> Demand is an income-generating factor since companies make profits only insofar as their output is sold. The role of a sales factor is to represent the demand side in the generation of income and for that it has to be measured at destination; that is, the conceptual basis for *sales by destination*. In comparison to *sales by origin*, sales by destination is a difficult element for companies to manipulate and thus due to its immobility it limits the overall impact of the formula on tax competition in the EU.<sup>397</sup>

The allocated share of the consolidated tax base to a group member on the basis of the sales factor is *calculated* as the total sales of the group member divided by the total sales of the entire group.<sup>398</sup> In principle, the sales factor includes all the proceeds from the sales of goods and provision of services, minus the discounts and returns, VAT, and

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<sup>392</sup> Art.91 (3) of the CCCTB Directive.

<sup>393</sup> European Commission, CCCTB/WP060\doc\en,p.12

<sup>394</sup> Art.91 (2) of the CCCTB Directive

<sup>395</sup> For the debate on the inclusion of sales factor and sales by destination see European Commission, CCCTB/WP060\doc\en,p.13.

<sup>396</sup> European Commission, CCCTB\WP\052\doc\en,p.9.

<sup>397</sup> European Commission, CCCTB/WP060\doc\en,p.12.

<sup>398</sup> Art.95 (1) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.12.

other taxes and duties.<sup>399</sup> The sales of goods and the provisions of services between a group's members are not taken into account in the sales factor, thus the transfer pricing issues will not arise.<sup>400</sup> In addition to the exclusion of exempted revenues, revenues from passive income such as interests, dividends and royalties as well as the proceeds from the disposal of fixed assets are not included in the sales factor unless they are accrued from the ordinary course of business.<sup>401</sup> The sales factor is *valued* according to the figures that are used in the calculating of the tax base.<sup>402</sup>

With regard to the *location* of the sales factor, sales of goods will be included in the sales factor of the group member located in the Member State where dispatch or transport of the goods to the person acquiring them ends. If this place is not identifiable, the sales of goods shall be attributed to the group member located in the Member State of the last identifiable location of the goods.<sup>403</sup> 'Supplies of services shall be included in the sales factor of the group member located in the Member State where the services are physically carried out'.<sup>404</sup>

### 2.6.5 Formulary apportionment evaluation

It should be noticed that the European Commission has learnt from the experience of the US and Canada in designing formulary apportionment for the EU. One of the most noticeable issues is the uniform apportionment formula, which would remove the immense administrative and compliance burden caused by transfer pricing for intra-community transactions, although it may come at the expense of higher flexibility.<sup>405</sup> In addition, the Commission makes the CCCTB formulary apportionment applicable to groups of companies, which will avoid the use of arm's length pricing. The formulary apportionment has the merit of solving the problem and distortion inherent in separate accounting under the arm's length approach.<sup>406</sup> In the formulary apportionment, the

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<sup>399</sup> Art.95 (2) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.12.

<sup>400</sup> Art.95 (2) of the CCCTB Directive.

<sup>401</sup> *Ibid*; European Commission, CCCTB/WP060\doc\en,p.13.

<sup>402</sup> Art.95 (3) of the CCCTB Directive; European Commission, CCCTB/WP060\doc\en,p.13.

<sup>403</sup> European Commission, CCCTB/WP060\doc\en,p.14.

<sup>404</sup> Art.96 (2) of the CCCTB Directive.

<sup>405</sup> Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.40.

<sup>406</sup> *Ibid*.

factors which represent where an entity earns its income will result in a fair and equitable distribution of income, based on where the companies actually do business. Since formulary apportionment would be implemented on a consolidated basis and allocate total net income, the opportunity for income-shifting within related entities would be eliminated.<sup>407</sup>

It can be argued that multinational enterprises may shift income by relocating apportionment factors. Nonetheless, this issue is not inherent to the apportionment itself and it is considered in the design of the formula and the composition of each factor. Each factor is precisely defined with regard to its location, value and scope. Moreover, ‘detailed rules on the calculation of the labour, assets and sales factors, the allocation of employees and payroll, assets and sales to the respective factor and the valuation of assets’<sup>408</sup> will be provided.

In order to avoid some of the drawbacks of using formulary apportionment – particularly the potential budgetary influence of the apportionment method on individual Member States tax revenues – and to react to changes in the business environment with an appropriate formula, a safeguard clause is set out in the CCCTB Directive, allowing the principal taxpayer or a competent authority to request the use of an alternative method for allocating the tax base. This is allowed where the outcome of the apportionment to a group member does not fairly represent the extent of the business activity of that group member.<sup>409</sup> Since the chosen apportionment formula concerns common interest, it has to be commonly agreed<sup>410</sup> by the competent authorities and the concerned committee.<sup>411</sup> However, in very exceptional cases the alternative approach should be applied and should not result in re-introducing the separate accounting and arm’s length to apportion the tax base.<sup>412</sup>

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<sup>407</sup> , Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on the Implementing Formulary apportionment in the EU* (Springer 2006) p.40. p.41.

<sup>408</sup> Art 97 of the CCCTB Directive.

<sup>409</sup> Art 87 of the CCCTB Directive

<sup>410</sup> *Ibid.*

<sup>411</sup> Art 132 of the CCCTB Directive

<sup>412</sup> European Commission, CCCTB/WP060\doc\en.p.17.

## 2.7 Corporate tax rates harmonisation and the CCCTB

### 2.7.1 Determining the tax liability

Corporate tax rate harmonisation is not a CCCTB objective.<sup>413</sup> The CCCTB does not infringe the tax sovereignty of EU-Member States to set their corporate tax rates.<sup>414</sup> They would apply their domestic tax rates on the allocated share of the consolidated tax base as calculated according to the formulary apportionment scrutinized above.<sup>415</sup>

The apportioned share will be liable to corporate tax in the respective Member State after reducing some deductions and adjustments.<sup>416</sup> The most important items to be deducted are double taxation relief, since the credit method applies to avoid double taxation with regard to the income received by a group member from a source outside the group and the amount of credit is only borne by the residence Member State of such a group member. Thus, the amount of credit granted is shared among the group entities according to formulary apportionment;<sup>417</sup> that is to say, a share of the foreign tax credit will be deducted from the apportioned share of the Member State concerned.

Moreover, unrelieved losses incurred by a taxpayer or permanent establishment according to the CCCTB rules or under the domestic corporate tax law before entering the group are not offset against the consolidated tax base. Therefore, such losses are carried forward and are offset against the apportioned share; namely, deducted from the share allocated to the group member concerned.<sup>418</sup>

Finally, the tax liability is calculated as follows: the apportioned share as calculated by the formula less any items deductible from the apportioned share and any double

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<sup>413</sup> European Commission, CCCTB\WP\020 (2005), p.3.

<sup>414</sup> This approach is a partial harmonisation which is defined as ‘a legally binding form of tax coordination between independent jurisdictions in the form equalisation of a selection of some not all relevant tax parameters e.g. mandatory common consolidated corporate tax base whereas the full tax harmonisation requires the equalisation of all relevant tax parameters including tax rates’. See C.Bellak and M.Leibrecht, *National tax policies in Europe: To Be or Not to Be* (Springer 2007), p.12.

<sup>415</sup> Art.103 of the CCCTB Directive.

<sup>416</sup> Art 102 of the CCCTB Directive

<sup>417</sup> Art 76 of the CCCTB Directive

<sup>418</sup> Art. 64 of the CCCTB Directive

taxation relief for income taxed at source. This will result in the adjusted apportioned share, the latter is multiplied by the national tax rate, and the result is the *tax liability* of a group member.

### 2.7.2 Corporate tax rates harmonisation in the EU

The overview on the current situation in the European Union regarding the corporate income tax rates shows that their rapid decrease in the EU continues. Despite this fall in corporate tax rates, however, they vary considerably in the EU.<sup>419</sup> Additionally, some Member States occasionally apply different levels of flat rates, depending on the size of a company and its profits. A split-rate approach also exists in some Member States, while in others the standard tax rates are increased by surcharge.<sup>420</sup>

It is well-known that differences in statutory corporate tax rates influence the location of investment. Investors tend to decide in favour of the location with the highest expected after-tax yield, even if the productivity and the before-tax yield of the firm are lower.<sup>421</sup> However, nominal tax rates are not useful estimates for the tax burden of real productive investment when the effects of the tax bases are not considered; that is, differences in tax bases are more effective.<sup>422</sup> They still embody an element in the general differences between existing domestic tax systems which influence capital allocation and profit-shifting. Thus, it can be argued that the harmonisation of corporate income tax rates could be an effective measure to improve tax neutrality and sufficiency.

In this respect, the European Commission tended to favour a harmonization or at least limits on differences in corporate tax rates as well as in tax bases in Europe. For example, in 1975 a minimum corporate tax rate in the EU was proposed as a range

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<sup>419</sup> European Commission, 'Taxation Trends in the European Union: Main results', 2009, p13.

<sup>420</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.55

<sup>421</sup> *Ibid*, p.95.

<sup>422</sup> Christoph Spengel, 'A Concept and Necessity of a Common Tax Base' in Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.3.



between 45% and 55 %.<sup>423</sup> These initiatives were not successful because Member States were reluctant to give up their sovereignty of setting their tax rates independently.<sup>424</sup> In addition, the differences in corporate tax rates in the EU are needed, in order to encourage tax competition, although the importance of tax competition is still a controversial issue.<sup>425</sup> The Commission has expressed the view that ‘a reasonable degree of tax competition within the EU is healthy and should be allowed to operate. Tax competition may strengthen fiscal discipline to the extent that it encourages Member States to streamline their public expenditure, thus allowing a reduction in the overall tax burden’, i.e. tax rates are seen as an instrument for having sound tax competition<sup>426</sup> and stimulating tax efficiency.<sup>427</sup>

Under the CCCTB project, corporate tax obstacles and economic distortions will be eliminated and at the same time corporate tax rate competition within the EU would not be affected. It is argued that the reduction of tax obstacles to cross-border investment by virtue of the CCCTB would intensify tax rate competition.<sup>428</sup> Moreover, the differences in corporate tax rates do not give rise to the same obstacles as those caused by differences in tax bases.<sup>429</sup> Therefore, the harmonisation of domestic tax bases is preferred over a harmonised tax rate. Furthermore, it is submitted that harmonising, or setting a minimum corporate tax rate as an alternative approach to the CCCTB, does not solve the most pressing problems. For example, a minimum tax rate will not deal with the problems of corporate taxation at the international level beyond European borders. If the minimum tax rate is set very high, profit could be shifted out of Europe. This makes the harmonisation of tax bases more effective than tax rate harmonisation.<sup>430</sup>

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<sup>423</sup> Birch Sorensen, ‘Company Tax Reform in the European Union’, *International Tax and Public Finance*, Vol.11, 2004, p.104.

<sup>424</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.105.

<sup>425</sup> See European Economic Advisory Group, ‘Report on the European Economy 2007’, Munich, 2007, at CESifo, pp. 121-132.

<sup>426</sup> European Commission, *Tax Policy in the European Union: Priorities for the years ahead* COM (2001) 260 final, p.4.

<sup>427</sup> Jesper Barenfeld, ‘A Common Consolidated Corporate Tax Base in the European union- A beauty or a Beast in the quest for Tax Simplicity’, *Bulletin for International Taxation*, July 2007, p.258; for more on tax rate competition see Paulus Merks, ‘Corporate Tax and the European Commission’, *Intertax*, Vol.36, 2008, p.6.

<sup>428</sup> *Ibid*, p.8.

<sup>429</sup> Memo of the CCCTB Directive, p.12.

<sup>430</sup> Jack Mintz, *Corporate Tax Harmonisation in Europe: It is All about Compliance*, *International Taxation and Public Finance*, Vol, 11, 2004, pp.221-234.

Overall, corporate tax rate harmonisation as an alternative to CCCTB, or applying minimum tax rates within the EU, is not an effective approach to deal with the current taxation obstacles to Europe-wide economic activities.<sup>431</sup> Moreover, full harmonisation of corporate tax systems including tax rates and bases is a far-reaching target, at least in the short term.<sup>432</sup> Therefore, under the CCCTB Directive, setting the corporate income tax rates would remain in the competence of Member States. However, the intervention of the EU is required in the form of targeted measures to prevent any harmful tax competition which could lead to a race to the bottom, or to manipulation of the latitude to set tax rates in income-shifting. The CCCTB scheme would not decrease tax competition, as Member States compete with each other through the corporate income tax rates and removing cross-border obstacles with the introduction of CCCTB would intensify that competition.<sup>433</sup>

## **2.8 The general attributes of the CCCTB in the EU**

### **2.8.1 The Subsidiarity principle and the CCCTB**

In principle, the CCCTB proposal is consistent with the principle of subsidiarity. In other words, the corporate tax obstacles in the EU are better tackled through a comprehensive solution at the EU level; namely, the CCCTB project. Non-coordinated action i.e. planned and implemented by each Member State independently, would complicate the current situation, as taxpayers would still need to deal with as many administrations as the number of jurisdictions in which they are liable to tax.<sup>434</sup> The CCCTB system respects the principle of subsidiarity by giving Member States the tax sovereignty for setting their corporate tax rates. Therefore, they are free to determine the desired size and composition of their tax revenues.<sup>435</sup>

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<sup>431</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.104.

<sup>432</sup> Ulrich Schreiber, 'Consolidation, allocation and International Aspects' in Wolfgang Schön, Ulrich Schreiber, and Christoph Spengel (eds.) *A Common Consolidated Corporate Tax Base for Europe* (Springer 2008), p.124.

<sup>433</sup> Birch Sorensen, 'Company Tax Reform in the European Union', *International Tax and Public Finance*, Vol.11, 2004, pp.91-115.

<sup>434</sup> Memo of the CCCTB Directive, p.9.

<sup>435</sup> European Commission, 'Impact Assessment accompanying the CCCTB Directive' SEC (2011)316, p.3.

## 2.8.2 The attributes of the CCCTB

The anticipated general attributes of the CCCTB according to the proposed Directive can be considered theoretically and based on empirical studies. Assuming that the CCCTB is correctly designed and implemented, its impact is assessed on the basis of the possibility of achieving the reduction of compliance cost; the elimination of double taxation; simplicity; tax neutrality; and economic efficiency in the EU.

In theory, simplicity, compliance cost reduction and elimination of double taxation can be achieved through a comprehensive CCCTB (replacing the current 27 national tax systems with one common regime) as outlined above. Moreover, consolidation, with its benefits of the elimination of intra-group transactions, would help to remove the heavy burden of transfer pricing requirements; a significant simplification and a radical reduction in compliance cost are expected.<sup>436</sup>

In addition, through consolidation and the elimination of intra-group transactions, the CCCTB would remove international judicial double taxation within the consolidated group, as well as the economic *double taxation* that results from the transfer pricing adjustments.<sup>437</sup> Therefore, the common tax system will make it easier, cheaper and more convenient to do business in the EU.<sup>438</sup>

It is expected that the CCCTB system will achieve tax neutrality. Although each group member is treated separately from a legal point of view, under the CCCTB the multinational enterprises are considered as integrated economic unit, and their profits and losses are consolidated. Therefore, The CCCTB is theoretically more consistent with the economic reality of a group of affiliated companies and has the potential to ensure tax *neutrality* with regard to the organisational structures of multinational enterprises. Moreover, tax neutrality would be achieved in respect to different modes of investment financing. By virtue of consolidation, intra-group transactions will be eliminated, including dividends payments and interest. Thus, the different modes of

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<sup>436</sup>Jesper Barenfeld, 'A Common Consolidated Corporate Tax Base in the European union- A beauty or a Beast in the quest for Tax Simplicity', Bulletin for International Taxation, July 2007,p.258

<sup>437</sup> *Ibid.*

<sup>438</sup> European Commission, 'European Corporate Tax Base: Making Business Easier and Cheaper' (2011) IP/11/319,p.1;Carsten Wendt, 2009, p.155.

financing at the corporate level would be treated equally for tax purposes, and consequently incentives to change the financial structure would not arise.<sup>439</sup> Under the consolidation mechanism, cross-border restructuring activities will be neutralised and will not trigger exit taxes as the transferred assets and exchanged shares would be ignored as intra-group transactions.<sup>440</sup>

The CCCTB-Formulary apportionment has the potential to satisfy the requirement of inter-nation equity,<sup>441</sup> and to cope better with the issues of simplicity and enforceability. The formulary apportionment implies a significant change to the current international tax system, since it replaces the internationally accepted arm's length principle. Formulary apportionment provides a pragmatic solution and a simple profit allocation among jurisdictions and it is not arbitrary. The factors of formulary apportionment are intended to ensure an allocation of the consolidated tax base to the profit-generating activities. These factors represent the elements that are deemed to generate the group's income. Thus, those countries in which there is a comparably larger share of the multinational enterprise's income-generating production factors will be attributed a larger share of the consolidated tax base. Therefore formula apportionment would achieve inter-nation equity.<sup>442</sup>

The removal of corporate tax obstacles, as outlined above, would allow businesses to make sounder economic choices. Thus, reducing tax distortion to investment decisions and increasing opportunities for cross-border investment would satisfy the objective of improving economic efficiency and the proper allocation of productive capital in the EU. The expected improvement in the simplicity, neutrality, and economic efficiency of the corporate income tax system in the EU would significantly contribute to achieving the objectives of the EU2020 Strategy.<sup>443</sup>

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<sup>439</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.154.

<sup>440</sup> *Ibid*, p.155.

<sup>441</sup> For definition of inter-nation equity see Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Application to the European Union in S Cnossen, *Taxing Capital Income in the European Union: Issues and Options* (Oxford 2000), p.54.

<sup>442</sup> Carsten Wendt, *A Common Tax Base for Multinational Enterprises in the European Union* (Gabler 2009), p.156.

<sup>443</sup> European Commission, 'Impact Assessment' SEC (2011)316, p.7.

From a practical point of view, empirical studies show a lot of variation with regard to the impact of the CCCTB on the size of the tax bases, the compliance cost and the Member States' tax revenues. Although the changes in the tax bases are not an objective, *per se*, of the CCCTB project, they are expected to exist. However, the analysis of the impact assessment of the European Commission shows that in the CCCTB's scenarios the aggregate tax bases would be left constant, in contrast with the status-quo ones.<sup>444</sup>

With regard to the influence of the CCCTB on the Member State tax revenues, a general conclusion cannot be drawn at the moment, as these effects will depend on the national tax policy of each Member State with respect to the available adaptation of the different tax instruments or the prevailing tax rates.<sup>445</sup> However, earlier empirical studies estimated the effects of the CCCTB on the size of tax bases and revenues of different Member States. Despite the fact that they have not been carried out according to the current CCCTB proposal, they nevertheless provide useful insights to the policy makers.<sup>446</sup> According to a study commissioned to Deloitte, the CCCTB is expected to translate into significant savings in compliance time and costs in the case of a multinational setting up a new subsidiary in a different Member State. It is estimated that a large enterprise spends over 0.23% of turnover in tax-related expenditure in order to open a new subsidiary in another Member State. The CCCTB will reduce these costs by 62%. The savings for a medium-sized enterprise are even more significant, as costs are expected to drop from 0.55% of turnover to a decrease of 67%. Additionally, the savings expected from the introduction of the CCCTB would amount to 8 percentage points of the compliance time.<sup>447</sup>

However, other studies have come to different conclusions. They state that under the CCCTB the compliance cost would go up by 13% due to the CCCTB distortions especially those that result from the application of formulary apportionment which outweighs the assumed decrease in the compliance cost and the elimination of transfer

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<sup>444</sup> European Commission, 'Impact Assessment' SEC (2011)316,p.5

<sup>445</sup> *Ibid.*

<sup>446</sup> Robert Cline, Tom Neubig, Andrew Phillips, Christopher Sanger, Aidan Walsh , 'Ernst&Young Study on the Economic and Budgetary Impact of the Introduction of a Common consolidated Corporate Tax Base in the European Union' (EYGM Limited 2010), pp.7-15.

<sup>447</sup> European Commission, The Impact Assessment accompanying document to the CCCTB Directive' SEC (2011)316, p.5.

pricing.<sup>448</sup> The formulary apportionment is seen as distortive because it does not reflect the underlying economics of modern business such as the lack of recognition of intellectual property. Moreover, the study finds that amongst the individual Member States there would be significant winners and losers with regard to revenue collection.<sup>449</sup> Furthermore, the effective corporate tax rate is seen to be increased under the CCCTB.<sup>450</sup>

### **2.8.3 The European reaction towards the CCCTB proposal**

The European reaction to the CCCTB proposal is somehow mixed. It shows both a relatively positive attitude and a preliminary negative reaction from several countries towards the commission's proposal. Firstly, the important interest groups and institutions in the EU have taken a fairly positive attitude towards the CCCTB proposal. So far the Union of Industrial and Employers' Confederations of Europe (UNICE) has supported the Common Consolidated Tax Base with formulary apportionment as a crucial goal for the EU corporate tax policy provided that CCCTB is optional and does not restrain tax competition.<sup>451</sup>

The European Economic and Social Committee (EESC) is on the whole in favour of the CCCTB proposal including the consolidation. However, the EESC is concerned about some issues that should be further developed, such as the social and economic impact of the CCCTB. Moreover, it states that some provisions in the proposal need to be clarified; for example, the treatment of financial assets, the position of intellectual property and the risk of formula apportionment implementation which could result in under or over taxation.<sup>452</sup> The Committee of the Regions' (CoR) Commission for Economic and Social Policy (ECOS) recognise the benefits of the CCCTB. However,

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<sup>448</sup> Robert Cline, Tom Neubig, Andrew Phillips, Christopher Sanger, Aidan Walsh, 'Ernst&Young Study on the Economic and Budgetary Impact of the Introduction of a Common consolidated Corporate Tax Base in the European Union' (EYGM Limited 2010), p.60.

<sup>449</sup> Spengel, Christoph; Ortmann-Babel, Martina; Zinn, Benedikt; Matenaer, Sebastian, 'A common Corporate Tax Base for Europe: An impact Assessment of the draft Council Directive on a CC(C)TB'(2012) ZEW Discussion Papers, No. 12-039, <<http://hdl.handle.net/10419/59576>>

<sup>450</sup> Ernst&Young, 'Major Developments: Common Consolidated Corporate Tax Base', issue 42 March/April 2011.

<sup>451</sup> Peter Birch, 'Company Tax Reform in the European Union', International Taxation and Public Finance, 11, 2004, p.96.

<sup>452</sup> EU tax centre, special CCCTB update, 'CCCTB proposal: current status' (2011) 175 Euro tax flash at <[www.kpmg.com/Global/en/.../taxnewsflash/.../ec-dec28-2011.pdf](http://www.kpmg.com/Global/en/.../taxnewsflash/.../ec-dec28-2011.pdf)> accessed 15 February 2013.

the ECOS has reservations on the proposal, in that the CCCTB does not apply to the local or domestic taxes on profits, and this means that business will be required to determine their tax bases under local rules in order to determine their tax liabilities for local or regional purposes.<sup>453</sup>

The Confederation Fiscal Europeene (CFE) supports the CCCTB as a great opportunity for tax harmonisation in the EU. However, it states that the CCCTB Directive is not clear in respect to its applicability towards third countries.<sup>454</sup> The European Parliament voted for certain amendments to the CCCTB proposed Directive, including making the CCCTB compulsory for certain types of companies after a transitional period.<sup>455</sup>

The European reaction, including Member States' opinions<sup>456</sup> and tax experts and practitioner's views towards the CCCTB proposal, presents several issues to be reconsidered. Primarily, most of the Member States support the general objective of the CCCTB as being to improve the function of the single market; the Member States who oppose the proposal of the CCCTB are rejecting it on the grounds of the principle<sup>457</sup> of subsidiarity.<sup>458</sup> The issue at stake is the tax sovereignty to be relinquished to the European Commission and jeopardised at the EU level. However, the subsidiarity argument is seen as a purely political argument, not an essential part of the debate, the technical stage of the proposal has been halted and the current discussion can be seen as political reluctance (Luxembourg, experts).<sup>459</sup> Another issue includes the implications of the CCCTB proposal on the revenue collection and the budgetary effects; this aspect is regarded as unclear, claiming that the CCCTB impact assessment as discussed above reveals some contradictions (Austria). Some Member States suggest that there should be more integration between the economies in the EU before implementing the

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<sup>453</sup> EU tax centre, special CCCTB update, 'CCCTB proposal: current status' (2011) 175 Euro tax flash at < [www.kpmg.com/Global/en/.../taxnewsflash/.../ec-dec28-2011.pdf](http://www.kpmg.com/Global/en/.../taxnewsflash/.../ec-dec28-2011.pdf)> accessed 15 February 2013.

<sup>454</sup> *Ibid.*

<sup>455</sup> *Ibid.*

<sup>456</sup> Bob Van der Made, 'EU: CCCTB Directive Status Update and Next Steps' *International Tax Review* Vol.22, No. 44, 2011, p.1.

<sup>457</sup> At the moment Nine Member States are objecting the CCCTB proposal; the UK, Ireland, Sweden, the Netherlands, Poland, Romania, Malta, Slovenia and Bulgaria.

<sup>458</sup> Kevin A. Bell, 'EU Member States Likely to Adopt Common Corporate Tax Base: May Omit Consolidated' [2011] *International Tax centre BNA*, p.1, available at [http://www.internationaltax.bna.com/itax/display/batch\\_print\\_display.adp?searchid=158650](http://www.internationaltax.bna.com/itax/display/batch_print_display.adp?searchid=158650) > accessed 11 November 2011.

<sup>459</sup> Matthew Gilleard, 'CCCTB: the view from Member States' *International Tax Review*, Vol.22, Issue 26, 2011, p.1.

consolidated tax base. They believe that consolidation with the consequence of offsetting losses and profits will not be fair, so they are seeking a CCTB without consolidation.<sup>460</sup>

Furthermore, the CCCTB proposal raises the issue of the unanimity requirement, which is claimed to be an obstacle to initiating the CCCTB Directive. It is believed that it is unlikely to be achieved in the foreseeable future (Germany).<sup>461</sup> However, some scholars believe that the CCCTB project is likely to be implemented through enhanced cooperation.<sup>462</sup>

The reduction of the compliance cost by the CCCTB is doubted by some Member States on the basis that the transfer pricing is already simple, and that replacing the OECD transfer pricing rules with consolidation will increase the costs (Ireland). The administrative cost will be high for the governments and the taxpayers, since the optionality of the CCCTB would mean that there would be two systems to comply with. Therefore the combination of a common tax base and different domestic tax bases has to be examined (Netherlands). The fairness of the apportionment of the consolidated tax base pursuant to the three factors of labour, assets and sales is questioned, especially for small States, as these factors tend to be located in the large countries. Accordingly, the latter would have a big share of the consolidated tax base (Malta, Cyprus).<sup>463</sup> Moreover, the formula apportionment is criticised, as it does not sufficiently reflect the real economy with its three production factors (Netherlands). Furthermore, certain types of assets are not included in the formula apportionment, such as financial and intangible assets, which would have significantly changed the allocation of the profits among the group members.<sup>464</sup>

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<sup>460</sup> Matthew Gilleard, 'CCCTB: the view from Member States' *International Tax Review*, Vol.22, Issue 26, 2011, p.1.

<sup>461</sup> *Ibid.*

<sup>462</sup> James J. Tobin, Esq. Ernst & Young LLP, 'CCCTB or Not to be', *Tax Management International Journal*, Vol.40, Issue 292, 2011, p.292.

<sup>463</sup> Zafirova, Anna, 'Cyprus: the Cypriot perspective on CCCTB', *International Tax review*, Vol. 22, Issue 43, 2011, available at <<http://www.internationaltaxreview.com/Article/2892109/Cyprus-The-Cypriot-perspective-on-CCCTB.html>> accessed 15 May 2013.

<sup>464</sup> Matthew Gilleard, 'CCCTB: the view from Member States' *International Tax Review*, Vol.22, Issue 26, 2011.



Some Member States claim that the CCCTB proposal is far-reaching at the moment, as it is complex, extensive and not detailed which raises significant uncertainty. It also has some rules which are less favourable than the national rules of some countries, such as the depreciation rules and the definition of assets, which only takes into consideration tangible fixed assets.<sup>465</sup> Some of the group businesses argue that the CCCTB will have a distortive effect on the fair tax competition, which is an essential driver of business and a critical instrument in the hands of Member States to attract investment through fiscal incentives.<sup>466</sup>

## **2.9 Conclusions**

This chapter shows that the introduction of the CCCTB into the EU is an answer to the challenge of the European economic integration. Globalisation has broadened the scope of economic relations. Moreover, the internal organisation of companies operating in international markets has changed as well. Nevertheless, tax systems in the EU have not kept up with these developments, and remain highly fragmented with 27 regimes that mostly collide. It would be better for the CCCTB system to be applied in the form of a Directive, and to be optional. This chapter examined the personal scope of the CCCTB. It will cover only corporations, and not include transparent entities. The main structures of the CCCTB were also analysed in this chapter, including the common tax base, consolidation and formulary apportionment. In respect to the common tax base, the chapter examined to what extent IFRS can be used a starting point for the design of common rules for tax base determination. It showed that the direct link between IFRS and tax accounting does not sufficiently exist. General principles of tax base calculation were briefly addressed. The benefits of consolidating the individual tax bases of the group members were dealt with. These include the removal of the problems that result from transfer pricing formalities, and the elimination of intra-group double taxation and high compliance cost. Moreover, the chapter showed that it is not possible to use consolidated IFRS accounts for the consolidation of the CCCTB. A group of companies are mainly subject to a consolidation mechanism, thus the chapter addressed the notion of group and defined the subsidiaries and permanent establishment that qualify for consolidation according to the CCCTB Directive. This chapter also highlighted the

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<sup>465</sup> Zafirova, Anna, 'Cyprus: the Cypriot perspective on CCCTB', *International Tax review*, Vol. 22, Issue 43, 2011.

<sup>466</sup> Matthew Gilleard, 'CCCTB: the view from Member States' *International Tax Review*, Vol.22, Issue 26, 2011.

main downsides of transfer pricing rules, which led to the adoption of the Formulary apportionment as a micro-based approach in the CCCTB. Subsequently, the three factors of the formulary apportionment; namely, sales, capital and labour, were defined.

Corporate tax rate harmonisation is not an objective in the CCCTB. However, this chapter suggested that corporate tax rates harmonisation as an alternative to CCCTB, or applying minimum tax rates within the EU would not be an effective approach to deal with the current taxation obstacles to Europe-wide economic activities. The chapter dealt with the general attributes of the CCCTB in the EU, indicating that the CCCTB proposal is consistent with the principle of subsidiarity, and that it is expected that the CCCTB system would achieve tax neutrality, reduce compliance cost, eliminate double taxation and achieve inter-nation equity through formula apportionment. Finally, the European reaction to the CCCTB proposal so far was highlighted; most of the European bodies and Member States show a positive attitude towards the CCCTB project. However, whether the CCCTB is to be adopted unanimously or through enhanced cooperation, a comprehensive evaluation of the CCCTB system has to take into account its interaction with the outside world; that is, third countries. These points will be examined in the chapters that follow.

### 3 The Territorial Scope of the CCCTB and its Implications

#### 3.1 Introduction

Currently, economic activities have been globalized. International trade and capital flows have been significantly enhanced due to the removal of restriction on capital markets and the growth in technical innovations such as information and communication technology.<sup>467</sup> The growth in international trade has promoted the mobility of economic activities.<sup>468</sup> Tax systems and policies, which were primarily designed to address domestic economic and social issues,<sup>469</sup> have changed in order to keep up with these developments. In other words, the accelerating process of globalization of trade and capital flow has fundamentally changed the influence that a national tax system would have on other economies and tax systems. For example, globalization has led, *inter alia*, to reform and reassessment of countries' tax systems, but it has also increased tax avoidance opportunities.<sup>470</sup> Similarly, in designing the CCCTB system, the effects of economic globalization should be considered.

At the international level, the CCCTB as a common tax system applicable in the EU will be put on a par with domestic tax systems of non-CCCTB Member States or third countries. Thus, in designing the CCCTB system its impact on other tax systems should be considered. In other words, the CCCTB should not hinder international trade and FDI flow between the CCCTB-Member States and third countries. In this respect, the CCCTB should avoid putting the EU at a disadvantageous position in worldwide tax competition.

In designing the international aspects of the CCCTB towards third countries, there are three issues to be considered: firstly, determining the territorial scope of the CCCTB, i.e. the eligibility of third countries entities to opt for the CCCTB, and the tax treatment of cross-border business activities between Member States and third countries; secondly, the protection of the common tax base against tax avoidance; thirdly, the

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<sup>467</sup> Vito Tanzi, *Taxation in An Integrating World* (The Bookings Institution 1995), p.5.

<sup>468</sup> Paulus Merks, 'Corporate Tax and the Global Village', *Intertax*, Vol. 34, Issue 1, 2006, p.26.

<sup>469</sup> Vito Tanzi, 'The Impact of Economic Globalisation on Taxation', *IBFD Bulletin*, 8/9 1998, p.338.

<sup>470</sup> OECD Report, 'Harmful Tax Competition, An Emerging Global Issue' (Paris 1998), p.14.

impact of the CCCTB system on the bilateral tax treaties concluded between Member States and third countries.

This chapter focuses only on the territorial scope of the CCCTB. The first issue to be addressed in designing the territorial scope is to determine which entities of a multinational group are eligible to be subject to the CCCTB. Based on the United States experience in applying the unitary business, this chapter argues that the CCCTB should not cover non-EU group entities, i.e. it should use the water's edge approach.

The second important issue to be addressed is the tax treatment of cross-border business activities between Member States and third countries. In this respect, a distinction can be made between inbound payments, i.e. foreign income, and outbound payments, i.e. EU-sourced income of third countries affiliates. Distinctive forms for inbound payments are an EU-parent company directly investing in a third country through a permanent establishment or a subsidiary. The parent company may receive dividends, interest income, or royalties. Typical patterns for outgoing payments are a third-country parent company investing in the CCCTB jurisdiction via a permanent establishment or a subsidiary. This company may receive dividend payments, interest income or royalties from its EU-subsidiary.

With regard to the tax treatment of foreign income earned in third countries, this chapter argues that such income should be included in the consolidated tax base and consequently apportioned among the group members.<sup>471</sup> In other words, the adoption of worldwide taxation by the CCCTB Directive will be justified in this chapter. However, as the CCCTB taxpayer is taxed on its worldwide income, the CCCTB has to provide common rules for double taxation elimination,<sup>472</sup> and anti-abuse rules in order to prevent the erosion of the common tax base. As regards the tax treatment of income earned in a CCCTB jurisdiction by a third-country company, it is argued that such

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<sup>471</sup> European Commission, 'Company Taxation in the Internal Market', (2001) Working Paper, SEC (2001)23, p.375; European Commission, 'Towards an Internal Market without tax Obstacles', COM (2001)582final, pp.15-16.

<sup>472</sup> European Commission, 'The Territorial Scope of the CCCTB', (2006, CCCTB/WG/026), pp.2-3.

income should be included in the consolidation and apportionment system in order to prevent tax avoidance opportunities.<sup>473</sup>

Due to the water's edge approach (i.e. consolidation and formulary apportionment are limited to the territory of the EU), the traditional separate accounting under the arm's length principle continues to apply to business activities with respect to third countries.<sup>474</sup> Thus, profit-shifting opportunities will exist via relationships with affiliates outside the EU, and the protection of the consolidated tax base against tax evasion would be necessary.

Another issue to be addressed in designing the CCCTB territorial scope is to determine a company's residence and the existence of a permanent establishment. Common definitions of tax residency and permanent establishment should be introduced. Different definitions may give scope for tax planning and contradict the objective of the CCCTB to introduce common tax rules in order to reduce compliance costs.

To this end, this chapter will be divided into four main sections. The first section justifies the choice of the water's edge approach in the CCCTB on the basis of the US experience in using *worldwide combined reporting* and *water's edge* concepts. It also determines the limitation of the CCCTB's water's edge. The second section examines the tax treatment of cross-border business activities between Member States and third countries under the CCCTB Directive. There are two alternative methods for the taxation of income which results from cross-border business activities, i.e. source-based taxation and residence-based taxation. This section thus also examines which of these approaches is adequate for the CCCTB system. The third section addresses the rules that will govern the transactions between the members of the consolidated group and their related entities resident in third countries i.e. transfer pricing rules. The final section deals with the common definition of company residency and permanent establishment as provided in the CCCTB Directive.

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<sup>473</sup> European Commission, 'International Aspects in the CCCTB, (18/11/2005, CCCTB\WP\019\doc\en)p.3.

<sup>474</sup> Art. 79 of the CCCTB Directive.

### 3.2 Worldwide consolidated tax base or water's edge for the CCCTB

A critical issue to be addressed when analysing the implementation of the CCCTB system is to define its territorial scope of application, i.e. whether the CCCTB applies worldwide consolidation and apportionment or is limited to the boundaries of the EU. Addressing the territorial scope of the CCCTB touches upon the principles of *worldwide* and *water's edge* combined reporting.<sup>475</sup> Generally, in the context of corporate tax income, “combined unitary reporting is a methodology for determining or apportioning the business income of a corporation which is a member of a commonly controlled group of corporations engaged in a unitary business”.<sup>476</sup>

According to worldwide unitary combination, income from ‘each company which is a part of a unitary business group – irrespective of the jurisdictional boundaries – is added together to determine the combined income of the entire corporate group’.<sup>477</sup> The combined income is apportioned on a basis of apportionment factors – sales, capital and labour.<sup>478</sup> Thereby, the concept of unitary taxation considers the integration of the unitary business, as the breakdown of a business unity would affect the accuracy of the combined tax base allocation.<sup>479</sup> The worldwide combined reporting approach has been related to the ‘unitary business’ concept.<sup>480</sup> It is also regarded as a result of unitary business.<sup>481</sup>

Under the ‘water's edge’ combined reporting, a state cannot look beyond the water's edge, i.e. beyond its boundaries. Accordingly, the combined report includes the income of all members of a unitary group, except for certain group members that are

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<sup>475</sup> For the underlying theory of combined reporting system see Michael J. McIntyre, ‘The Use of Combined Reporting by Nation-States’ in Brian J. Arnold, Jacques, Eric M. Zolt (eds.) *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation 2003), p.245.

<sup>476</sup> Schadewald, Michael, ‘Worldwide Versus Water's-Edge Combined Reporting’, *Journal of State Taxation*, Vol.30, No. 1,2011, pp.43-48.

<sup>477</sup> George N. Carlson, Harvey Galper, ‘Water's Edge Versus Worldwide Unitary Combination’ in Charles E. McLure Jr (ed.) *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover institution Press Stanford University Stanford 1984), p.1.

<sup>478</sup> *Ibid.*

<sup>479</sup> Charles E. McLure Jr, ‘Defining a Unitary business: An Economist's view’, in McLure Jr (ed.) *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover institution Press Stanford University Stanford 1984), p.89.

<sup>480</sup> In the parlance of the United States, the unitary business is referred to as a ‘Common Enterprise’; this term is used to define the group in the US subnational income taxes.

<sup>481</sup> Philip Baker/ Ioanna Mitroyanni, ‘the CCCTB rules and Tax Treaties’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) ,p.632.

incorporated in a foreign country or conduct most of their business activities abroad. Thereby, the territorial borders are taken into account, and only the part of a unitary business related to a given jurisdiction is included in the combined report. This means that the integration of a unitary business is partly kept, at least at the domestic level.<sup>482</sup>

### 3.2.1 Overview of the US experience in combined reporting

Originally, the principles of water's edge and worldwide combined reporting appeared and developed in the context of corporate taxation in the United States. However, they constituted a controversial issue for a long period of time, and led to the abandoning of worldwide corporate income consolidation and to a shift towards the water's edge concept.<sup>483</sup> The departure from worldwide combined reporting was in response to opposition from the multinational enterprises: the federal government of the United States, as well as non-US governments were opposing the worldwide principle.<sup>484</sup>

Moreover, the application of the worldwide consolidation principle in the US resulted in a high compliance cost, and double taxation. Worldwide reporting causes double taxation, due to the overlap in the tax base and the differences in the profitability among jurisdictions that have taxing rights over members of the single group. Worldwide combination causes multinational enterprises to suffer additional compliance costs and taxes.<sup>485</sup> More specifically, the non-US group members endured complex administrative compliance obligations. According to the Model of Multistate Tax Commission, those group members are required to adjust their profit and loss statements, to bring them in line with the US GAAP. Subsequently, profit and loss statements had to be adjusted in order to conform to the tax accounting standard required by the state tax Code concerned. All these adjustments made the multinational enterprises suffer additional

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<sup>482</sup> Philip Baker/ Ioanna Mitroyanni, 'the CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) ,p. 632

<sup>483</sup> See S. Ct.1983, container corp of America v Franchise tax board, 436 U.S. 159 available at <<http://caselaw.lp.findlaw.com/cgi-bin/getcase.pl?court=us&vol=463&invol=159> > accessed 10 March 2012 ; S. Ct .1994, Barclays bank v. franchise tax board 512 U.S. 298, 114 S. Ct. 2268 at <<http://www.law.cornell.edu/supct/html/92-1384.ZS.html> > accessed 11 March 2012.

<sup>484</sup> Nadine Riedel, Marco Runkel, 'Company Tax Reform with A Water's edge', *Journal of Public Economics*, Vol.91, 2007, pp.1533-1554 at 1535.

<sup>485</sup> Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', *State Tax Notes*, Vol.60, 1993, p.407.

cost under the worldwide reporting principle. Additionally, the worldwide combining concept was seen by the US federal government as a disincentive to investment. Moreover, the shift into the water's edge principle in the US has been largely a result of a political pressure.<sup>486</sup> This is because the application of worldwide combination created a tension in the commercial relations of the US.<sup>487</sup>

In support of worldwide combined reporting, it has been argued that double taxation occurs due to the absence of common rules for calculating the tax base and a common allocation mechanism, i.e. each state in the US calculates its tax share separately. In other words, double taxation would exist even under the water's edge approach. However, it is submitted that the differences in sub-federal rules are not as significant as at the international level, by virtue of the common federal tax base and the 'Massachusetts' formula apportionment. Accordingly, the profitability gaps are expected to be sharper in a global context than at the domestic level, which makes double taxation more severe under the worldwide combination scheme.<sup>488</sup>

Despite the disadvantages of the worldwide combined reporting, the Supreme Court justified its emergence in the US by the need to satisfy the US constitutional framework.<sup>489</sup> Furthermore, since the definition of unitary business is not by nature based on jurisdictional contours,<sup>490</sup> the application of the worldwide combined reporting in the US was necessary for an accurate computation of the unitary business income. In

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<sup>486</sup> Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', *State Tax Notes*, Vol.60, 1993, p.407

<sup>487</sup> S. Ct. 1994, *Barclays bank v franchise tax board* 512 U.S. 298, 114 S. Ct. 2268 at <<http://www.law.cornell.edu/supct/html/92-1384.ZS.html> > accessed 15 March 2012; Eric J. Coffill, 'A Kinder, Gentler 'Water's Edge' Election: California Wards off Threats of UK Retaliation as Part of Comprehensive Business Incentive Tax Package', Vol. 61, no. 4 *Tax Notes*, 1993, pp.477-87.

<sup>488</sup> Philip Baker/ Ioanna Mitroyanni, 'the CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008) ,p. 634.

<sup>489</sup> See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

<sup>490</sup> The Unitary business was defined as

'The one in which there is a unity of ownership, unity of operation and unity in use. Unity in ownership means that the activities outside the jurisdiction, combined with in-state operations are owned by the same taxpayer. Unity of operation can be proven by central purchasing, advertising, accounting and management divisions. Unity in use can be found in centralised executive force and a general system of operation';

for more on the concept of unitary business see Peter G. Chen, 'State Taxation of Unitary Businesses', *Fordham Urban Law Journal*, Volume 8, Issue 4, 1979, pp.819-856 at 833; Kobetzky, Michael, 'The Case for Unitary Taxation of International Enterprises', *Bulletin for International Taxation*, Vol.5, 2008, pp. 201-215.



other words, its application was needed to be in line with the nature of the definition of unitary business.<sup>491</sup>

### 3.2.2 The water's edge limitation in the USA

Generally, as regards the common tax legislation in the US, despite the failure of legislative attempts to enact any common legislation the pressures of market forces led the states to further harmonize their corporate income tax laws. In support of this harmonization, in 1967 the State Tax Administration Associations developed a model of state tax statute: this is the Multistate Tax Compact (MTC). As a result of the MTC the Multistate Tax Commission was established.<sup>492</sup> This Commission encourages states to adopt uniform state tax laws and regulations that apply to multistate and multinational enterprises.<sup>493</sup> However, the MTC produces soft law. In this regard, the MTC model provides for the limitation of the water's edge approach; it also specifies the requirements for a unitary group member to qualify for election of water's edge.<sup>494</sup>

The water's-edge rule was enacted in the US in 1993.<sup>495</sup> The limitation of the water's edge combined reporting in the US is drawn on a broad basis. Water's edge includes all jurisdictional or domestic group corporations which opted for a combined reporting system insofar as they belong to one single unitary business. The water's edge regime even extends beyond the territorial scope of the US: it includes foreign group members which belong to a single unitary business if they carry out substantial business activities or have a permanent establishment in the group jurisdiction. For example in California, foreign entities are included in the water's edge system if twenty percent or more of

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<sup>491</sup> Philip Baker/ Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *The Common Consolidated Corporate Tax Base* (Linde 2008), p. 632.

<sup>492</sup> In the US, tax harmonisation procedure was initiated in 1916 under the supervision of the National Tax Association (NTA). In 1957, the National Conference of Commissioners on Uniform States Laws presented the proposal on the Uniform Division of Income for Tax Purposes Act (UDITPA) the main aim of the UDITPA was to render a uniform scheme to the division of multi-state enterprise's income. It is not a federal Act; it is rather a guideline for individual states to structure their corporate income tax law on a uniform basis. See < [www.mtc.gov/Uniformity.aspx?id=472](http://www.mtc.gov/Uniformity.aspx?id=472)>; <[www.mtc.gov](http://www.mtc.gov)> accessed 22 February 2013.

<sup>493</sup> Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level' (1999) U.S. Department of the Treasury OTA Paper No.83, p.11.

<sup>494</sup> See Multistate Tax Commission, Proposed Model Statute for Combined Reporting, August 17, 2006, Section 5.A

<sup>495</sup> See California Stat. 188, 1993.

their business activities – as calculated according to the three factors of formula apportionment (i.e. property, payroll and sales) – is conducted within the US jurisdiction.<sup>496</sup> A foreign entity is a company that is resident outside the nation-state or the group jurisdiction of the combined reporting regime.<sup>497</sup> The group of corporations required to file a combined report under the water's edge approach are referred to in this chapter as the water's-edge consolidated group.

Generally, under the US water's-edge approach, the foreign source income of domestic entities, which are included in the water's edge consolidated group, is includible in the combined group's income.<sup>498</sup> However, some states that adopted a water's-edge approach did not tax the foreign income of a domestic entity that has been included in the water's edge consolidated group. It is submitted that this practice is not justified from a fiscal point of view; it has been carried out for political purposes.<sup>499</sup>

On the one hand, the scope of the water's edge consolidated group in the US is relatively broad in order to keep the unity of a unitary business; the fragmentation of the unitary business would be very distorting. Moreover, such limitation is made in order to combat the driving of business revenues away from the water's edge,<sup>500</sup> and to discourage practices of artificially shifting income beyond the water's edge. On the other hand, where some members of a combined group are allowed to opt out of the combined report under the water's-edge approach, tax avoidance opportunities would occur. Thus, anti-avoidance rules controlling tax haven abuse, such as the CFC rules, and rules disallowing the deduction for interest, royalties and other payment will be required.<sup>501</sup> The water's edge rule makes the combined reporting system more complex, especially as the combined reporting system is based on the concept of the unitary

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<sup>496</sup> Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', Brian J. Arnold, Jacques, Eric M. Zolt (eds.) *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation 2003), p.245.

<sup>497</sup> *Ibid.*, p.293.

<sup>498</sup> See California Revenue and Taxation Code sections 25110(a) (2) and (3) (West Supp. 2001).

<sup>499</sup> Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', p.292.

<sup>500</sup> William D. Dexter, 'Attribution of A Multinational Corporation's Net Income: the Position of Unitary States Regarding Combined Reporting', *Vanderbilt Journal of Transnational Law*, 1985, pp.311, 325.

<sup>501</sup> Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', Brian J. Arnold, Jacques, Eric M. Zolt (eds.) *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation 2003), p.295.

business, which in turn does not have a standard definition.<sup>502</sup> Moreover, it is incompatible with the underlying concept of the combined reporting system, i.e. group notion, which is not limited by jurisdictional boundaries.<sup>503</sup>

### **3.2.3 Water's edge or worldwide consolidated group in the European CCCTB: Some lessons from the US experience**

In essence, it cannot be said that the US experience in corporate taxation is entirely relevant for the EU. In other words, the EU cannot endorse a worldwide consolidated group or a water's edge consolidated group merely on the basis of the US experience in this respect, but the US experience in corporate taxation provides some lessons for the EU as it initiates the CCCTB scheme.<sup>504</sup>

The US experience should not form the main reference for designing the CCCTB consolidated group, as the institutional arrangements and corporate tax settings in the EU are different from the US ones. As of today, virtually all the US States apply corporate income taxes. Like the EU Member States, the US states have fiscal sovereignty in respect to the choice of tax rules and corporate tax rates. Nevertheless, none of the US states has full independence in setting corporate income tax rules. The definition of the taxpayer and the tax base, the concepts of realisation and recognition, and the principle of accounting are based upon the federal legislation. For a corporate group, the income is calculated at the unitary business level, i.e. consolidated.<sup>505</sup>

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<sup>502</sup> Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level' (1999) U.S. Department of the Treasury OTA Paper No.83, p.17.

<sup>503</sup> William D. Dexter, 'Attribution of a Multinational Corporation's net income: the Position of Unitary States regarding Combined Reporting', *Vanderbilt Journal of Transnational Law*, 1985) P.311, available at [http://heinonline.org/HOL/Page?handle=hein.journals/vantl18&div=21&g\\_sent=1&collection=journals](http://heinonline.org/HOL/Page?handle=hein.journals/vantl18&div=21&g_sent=1&collection=journals) > accessed 20 March 2012.

<sup>504</sup> Some scholars have suggested the application of combined reporting in the EU, but the issue was whether Member State should be working towards worldwide harmonisation or regional harmonisation, see for example Alicia H. Munnell, 'Taxation of Capital Income in a Global Economy: An Overview', *New England Economic Review*, September-October 1992, pp. 33-51; Charles E. McLure, 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the US Experience', in Grammie, M., Robinson, B. (Eds), *Beyond 1992: A European Tax System* (1987- Institute For Fiscal Studies, London), pp. 39-51, at 46.

<sup>505</sup> Johanna Hey, 'EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity' (2008) New York University School of Law, Working Paper 02/08, p.23.

As regards the tax treatment of inter-state business activities and multistate groups, the US distinguishes between business and non-business income. Business income of a unitary business is apportioned pursuant to a formula which is based on three equally weighted factors, i.e. labour, capital and sales. Non-business income is not subject to formula apportionment. Formula apportionment applies where the income of the group is consolidated, but consolidation is not compulsory in all states, i.e. in some states it is elective. The apportionment mechanism also differs widely across the US. The states apply an extensive variety of different apportionment formula. Although the formula apportionment is used by all states, nevertheless, the weight of each single factor differs significantly. The components of the formulae diverge greatly, as does the determination of the factors. However, the only feature applied identically by all US states is the 'water's edge limitation'.<sup>506</sup> Overall, therefore, it can be submitted that the US corporate tax system is *far from being uniform*, and the *combined reporting system* is not *applied uniformly*.

The existence of the fundamental freedoms in the EC Treaty and the jurisprudence of the ECJ on equal treatment indicate a different setting in the EU from that of the US. There is no binding multi-state treaty in the US. The equal protection clauses provided in the US constitution, such as the Commerce and Due process clauses, would be analogous to the fundamental freedoms of the EC Treaty. These clauses eliminate discriminatory tax treatment against inter-state business activities, and put restrictions on the taxing rights of the individual states.<sup>507</sup> However, the Congress has not used these clauses to oblige the states to adopt uniform tax rules.<sup>508</sup> The US Supreme Court does not in fact apply the Commerce clause properly, as it interprets it in a narrow way, particularly in respect to the apportionment mechanism and the principle of fair apportionment. For example, although the application of different formulae in different states results in double taxation or non-taxation, this practice is not regarded as

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<sup>506</sup> Johanna Hey, 'EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity' (2008) New York University School of Law, Working Paper 02/08, p.26.

<sup>507</sup> Stephen W. Mazza and Tracy A. Kaye, 'Restricting the Legislative Power to Tax in the United States', *The American Journal of Comparative Law*, vol.54, pp. 641-670, available at <<http://www.jstor.org/stable/20454556>> accessed 22february 2013.

<sup>508</sup> McLure, Charles E. and Hellerstein, Walter, 'Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals', *State Tax Notes*, Vol. 31, No. 9, March 1, 2004. Available at <SSRN: <http://ssrn.com/abstract=510582>>.

discriminatory<sup>509</sup> or an infringement of the concept of fair income allocation.<sup>510</sup> The only restriction that remains according to the Commerce and Due Process is that a state only taxes income produced by the taxpayer's activities with which the state has a substantial connection.<sup>511</sup>

There is a lack of harmonisation and uniformity in respect to corporate tax systems in the EU and the US. Nevertheless, the problems related to corporate taxation in the EU is different from those that exist in the US. The solutions suggested for these problems reveals<sup>512</sup> that the EC has been structured to serve different objectives and principles from the US ones.<sup>513</sup> This can be found with regard to the legislative process that influences taxation issues, and the bodies that regulate these rules.<sup>514</sup> Furthermore, the legislative initiatives that have been undertaken by the EU in the field of direct taxation show a vision for a more competitive and neutral Internal Market, whereas this is not a priority in the US.<sup>515</sup> For example, the current applicable version of the EC Treaty prioritises the abolition of double taxation.<sup>516</sup>

### 3.2.4 The European choices

With respect to the design of the territorial scope of the CCCTB, the EU should make a choice that sufficiently accommodates its own objectives and structures, and that eliminates the current corporate tax obstacles. This is because, as noted above, the main settings and problems of the corporate tax are different from the ones in the US. Nonetheless, there are still some lessons to be learnt from the US experience.

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<sup>509</sup> Kathryn L. Moore, 'State and Local Taxation: When will the Congress Intervene' *Journal of Legislation*, Vol.23, 171, 1997, p.205.

<sup>510</sup> Johanna Hey, 'EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity' (2008) New York University School of Law, Working Paper 02/08.p.31.

<sup>511</sup> Walter Hellerstein, 'The European Commission Report on Company Income Taxation: what the EU can Learn from the Experience of the US States', *International Taxation and Public Finance*, Vol.11,2001,pp. 199-220, at 205.

<sup>512</sup> Sijbren Cnossen, 'Reform and Coordination of Corporation Taxes in the European Union: An alternative Agenda', *IBFD*, 2004, pp. 134-150, at 143.

<sup>513</sup> Malcolm J. Gammie, 'Corporate taxation in Europe - Paths to a Solution', *British Tax Review*, 2001, pp.233-249 at 230.

<sup>514</sup> Charles E. McLure. *Harmonizing Corporate Income Taxes in the US and the EU: Legislative, Judicial, Soft law and Cooperative approaches*, *CESifo Forum* 2/2008, pp. 49-51.

<sup>515</sup> Philip Baker/ Ioanna Mitroyanni, 'the CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) ,p. 632.

<sup>516</sup> Elena Gonzalez Sanchez, 'Corporate Tax Harmonisation in the European Union: Harmonisation of the Tax Connecting Factors', *Universidad Del País Vasco. Servicio Editorial*, 2005, p.32.

The EU economies are highly integrated, meaning that the landscape is ready for corporate tax harmonisation. The CCCTB system that replaces the current EU 27 tax systems with a single set of rules for calculating the tax base would achieve corporate tax uniformity. Once the common corporate tax rules are introduced, a mechanism for taxing the multinationals enterprises, i.e. consolidation and formulary apportionment, will be established. The CCCTB Directive allows for consolidating the income of a group of companies operating in the EU and the apportionment of the consolidated tax base according to formula apportionment. The separate accounting approach under the arm's length principle is no longer an adequate method for allocating the income of a group of companies in an economic integrated region such as the EU.

However, the EU needs to define the territorial scope of the 'consolidated group'. This scope could be limited to the boundaries of the EU, i.e. a water's edge consolidated group, or extended to the outside world, i.e. a worldwide consolidated group. A critical argument for the '*Worldwide consolidation*' is that it is consistent with the lessons of economic theory. In other words, unitary taxation should form an economic perspective in order to ensure an accurate allocation of the tax base. This requires that the entire unitary business as a whole is taken into account for the calculation of the profits forming part of the apportionable taxable base. Moreover, implementing worldwide consolidation in the context of the CCCTB would not result in the same flaws, such as a high compliance cost as in the US. This is mainly because the latter does not enjoy corporate tax uniformity as the EU would under the CCCTB.<sup>517</sup>

However, the drawbacks that resulted from the application of worldwide combined reporting in the US, such as double taxation, would lead the EU to approve water's edge consolidation. The EU shows intolerance towards double taxation. The legislative initiatives issued by the EU on equal treatment and on the harmonisation process mirror a vision of a neutral internal market. In this context, the elimination of double taxation is one of the EU's long term objectives.<sup>518</sup> It is submitted that unlike the US situation, a group of companies operating in the EU would suffer severe double taxation if they

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<sup>517</sup> Johanna Hey, 'EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity' (2008) New York University School of Law, Working Paper 02/08, p.36.

<sup>518</sup> Art. 293 of the EC Treaty. However, this article is not included in the TFEU.

were subject to a worldwide consolidated approach.<sup>519</sup> This is because there is no constitutional principle equivalent to the Commerce or Due Process clauses in the EU. Namely, there would be an inevitable overlap between the share of the global group tax base allocated to the EU and the revenues taxable by third countries.<sup>520</sup>

Moreover, like the US, the EU would adopt water's edge consolidation for political and legal reasons. A water's edge consolidated group is considered to be practical from a political point of view.<sup>521</sup> The concept of unitary business is not valid as a basis for the determination of the scope of the CCCTB consolidated group. It would not achieve the aims of facilitating investments in the EU and respecting bilateral and international agreements between the EU Member States and third countries at the same time.<sup>522</sup> Therefore, using the unitary business concept for defining the scope of the CCCTB consolidated group seems unachievable at this stage.<sup>523</sup>

However, the endorsement of a water's edge scheme has been set out as a clear policy for CCCTB group taxation in the EU.<sup>524</sup> It follows that the outer limit of the CCCTB group has been drawn so as to coincide with the territory of the EU, and this is supported by the academic literature in the field of EU group taxation.<sup>525</sup>

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<sup>519</sup> Kathryn L. Moore, 'State and Local Taxation of Interstate and Foreign Commerce: The Second Best Solution', *Wayne Law Review*, Vol.42, 1996, pp.1426-1504, at1450.

<sup>520</sup> Philip Baker/ Ioanna Mitroyanni, 'the CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008) at 632.

<sup>521</sup> European Commission, 'Formulary Apportionment and Group Taxation in the EU: insights from the United States and Canada' (2005) Working paper No. 8/2005, p.35.

<sup>522</sup> *Ibid.*

<sup>523</sup> Agundez-Garcia 'the Delineation and Apportionment of a European Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: A Review of Issues and Options, (2006) Working paper No 9-2006, and p.20.

<sup>524</sup> European Commission, 'Company Taxation in the Internal Market', SEC (2001)1681, p.375; European Commission, 'Towards an Internal Market without Tax Obstacles, COM (2001)582 final, pp.15-16; European Commission, 'An Internal Market without Company Tax Obstacles: Achievements, ongoing initiatives and remaining challenges, (Communication) COM (2003)726 final, p.16.

<sup>525</sup> Lodin& Gammie, *Home State Taxation* (2001 IBFD, Amsterdam), pp.45, 46.

### **3.3 Water's edge limitation in the European CCCTB scheme**

Determining the limitation of the CCCTB water's edge involves the examination of some critical issues. Firstly, the eligibility of third-country entities to opt for the CCCTB system, and subsequently to be included in the consolidated tax base if they form a part of a unitary group, will be examined. In this respect, possible scenarios of consolidated group structures that involve third-country entities will be highlighted. Secondly, this section will examine the effect of the water's-edge limitation on the tax treatment of the foreign source income of domestic companies that are included in the consolidated group. Finally, limiting the CCCTB consolidated group to the water's edge of the EU would have an implication to be examined. This is that transactions between the consolidated group and its related parties outside the EU would continue to be governed by separate accounting under the arm's length principle.

#### **3.3.1 The eligibility of third-country companies to opt for the CCCTB system**

According to the CCCB Directive, companies established under the laws of an EU Member State which take the form of a 'corporation', and are subject to corporate tax will be covered by the CCCTB system.<sup>526</sup> Similarly, the CCCTB Directive applies to companies established under the laws of a third country when such companies have a similar form to the list in Annex I. In addition, these companies must be subject to one of the corporate taxes listed in Annex II.<sup>527</sup> Since the basic idea of this eligibility test is to include the setting where the company is resident in an EU Member State and subject to its corporate tax, it also covers the case where the company is resident in a third country but is subject to tax in respect of a *permanent establishment* in an EU Member State.<sup>528</sup> The Directive states that the Commission will draw up an annual, non-exhaustive list of third country companies' forms, which will be considered to satisfy these conditions.<sup>529</sup> However, the fact that a company form is not included in the list of third company forms does not mean that such company form is not subject to the

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<sup>526</sup> Art. 2(1) of the CCCTB Directive.

<sup>527</sup> Art. 2(2) of the CCCTB Directive.

<sup>528</sup> European Commission, 'Eligibility Testes for Companies and Definition of a CCCTB group' (CCCTB/RD/001), 30 August 2010.p.3.

<sup>529</sup> Art.3 of the CCCTB Directive.



CCCTB Directive. This is justifiable as it is not realistic for the Commission to be kept updated of all changes in corporate taxation around the world.<sup>530</sup>

This approach would appear to promote clarity and simplicity, and would not deviate from the CCCTB objective of creating a common and comprehensive tax base for tax purposes in the EU. In contrast, the exclusion of certain types entities that are liable to corporate taxation would lead to situations where the CCCTB and current domestic tax rules would have to be applied concurrently, which would be burdensome and complex for taxpayers and administrations, and hence would not fulfil the basic purpose of the CCCTB.

The CCCTB Directive merely stipulates that the company *is subject to* one of the corporate taxes, but it does not provide whether the ‘subject to tax’ test, i.e. the tax liability, should be derived from the domestic law of the respective Member State or should be specified according to the CCCTB provisions. In this respect, a distinction can be made between companies which are exempt from domestic corporate tax to which the CCCTB Directive may apply, and companies which are basically not subject to domestic corporate tax and thus do not fall under the scope of the CCCTB Directive. Unlike the Interest and Royalties Directive which requires that the company is subject to tax without being exempt,<sup>531</sup> the CCCTB Directive did not follow this approach. This may suggest that the company will fall within the ambit of the CCCTB even if it is tax exempt.

Presumably, the ‘*subject to tax*’ test would have to be determined on the basis of the domestic law of the Member States concerned. However, it is submitted that the above distinction is not important from a legal policy perspective, as it would make the domestic legislative techniques relevant for the purposes of Union law.<sup>532</sup> It is suggested that the wording of such provision should be revised in order to avoid an abusive interpretation. For example, the wording of the equivalent article, the Parent-Subsidiary

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<sup>530</sup> Lang Michal, ‘The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base’ (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.16.

<sup>531</sup> Art.3 (1) (iii) of the Interest and Royalties Directive.

<sup>532</sup> Luca Cerioni, ‘The Commission Proposal for a CCCTB Directive: Analysis and Comments, Bulletin for International Taxation, 2001, pp.515, 216.

Directive, which states that the company must be subject to one of the taxes therein without ‘*the possibility of option*’,<sup>533</sup> could be followed.

When the company fulfils the above eligibility test, whether it is resident in an EU Member State or in a third country, it can opt for the CCCTB scheme.<sup>534</sup> However, a company to which the CCCTB system applies which is resident in third countries for tax purposes can opt for the system only in respect of its permanent establishment located in a Member State.<sup>535</sup> Equally, the qualifying subsidiary of a parent company resident in a third country can also opt for the CCCTB, assuming that the parent company satisfies the CCCTB eligibility test.<sup>536</sup>

This implies that the CCCTB water’s edge consolidation does not include foreign corporations resident in third countries. The limitation of water’s edge consolidation is based on the criterion of tax residency within the EU boundaries.<sup>537</sup> In other words, a group of corporations engaged in a unitary business would not include foreign corporations in the consolidated group. As outlined above, EU-permanent establishments are an exception to this rule. For purposes of this rule, a foreign corporation is a corporation that is resident outside the EU or a regional group that operates the CCCTB system.<sup>538</sup>

It can be argued that the exclusion of third-country affiliates from the CCCTB consolidated group would lead to the fragmentation of the business unity, and the risk of tax-avoidance. Nevertheless, the risk of tax abuse remains the same as under the worldwide consolidated group. This is because such risk is directly related to the rules determining group membership and not to the group’s geographical scope.<sup>539</sup>

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<sup>533</sup> Art.2 (1) (c) of the Parent-Subsidiary Directive.

<sup>534</sup> Art. 6(1) of the CCCTB Directive.

<sup>535</sup> Art. 6(2) of the CCCTB Directive; European Commission, (CCCTB/RD/001), Eligibility testes for companies and definition of a CCCTB group, Brussels, 30 August 2010.P.3

<sup>536</sup> Art. 55(d) of the CCCTB Directive; Clemens Fuest , ‘The European Commission ‘s proposal for a Common Consolidated Corporate Tax Base’ ,Oxford Review of Economic Policy, Vol.24, No.4, 2008, p.720; European Commission, ‘CCCTB: Possible Elements of a Technical Outline’(CCCTB/WP057/doc/en, 26 July 2007), p.6

<sup>537</sup> Art.6 of the CCCTB Directive.

<sup>538</sup> European Commission, ‘Eligibility Testes for Companies and Definition of a CCCTB Group, (CCCTB/RD/001,30 August 2010), p.4

<sup>539</sup> Philip Baker/ Ioanna Mitroyanni, ‘the CCCTB rules and Tax Treaties’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008) ,p.635.

Importantly, as long as the CCCTB is accompanied by an anti-abuse rule and a clear definition of a consolidated group these risks would be lessened.

The water's-edge consolidation should not be optional. In other words, a group of corporations should not be allowed to elect to include all members of the group in the consolidated report or to include only the water's-edge members. The optionality would cause an irregularity in favour of the taxpayer, as the taxpayer would be able to exercise the optionality so as to minimize its taxes.<sup>540</sup>

### **3.3.2 Structures of the CCCTB consolidated group that involve third-country intermediaries**

Determining the precise scope of the CCCTB consolidated group in relation to third countries is an important issue. It would promote a sufficient allocation of taxing rights and apportionment of the consolidated tax base between Member States and the third countries. In principle, under the CCCTB Directive, the definition of the consolidated group is based on technical features: ownership and voting rights.<sup>541</sup> Compared to the concept of unitary business, this entitlement test is compatible with the water's edge principle.<sup>542</sup> Moreover, defining the entities that form part of the consolidated group is based on their tax residency within the water's edge of the EU.<sup>543</sup> However, the formation of the consolidated group would inevitably involve third country intermediary entities.<sup>544</sup> Therefore, the question arises as to whether the CCCTB can be applied to a group of companies that comprises an EU-resident parent and its subsidiaries or permanent establishment which are controlled by a non-EU parent. In this respect, some scenarios of the group structures will be examined.

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<sup>540</sup> Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold, Jacques Sasseville, Eric M. Zolt(eds.) *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation 2003), p.295.

<sup>541</sup> Arts. 54, 55 of the CCCTB Directive.

<sup>542</sup> European Commission, 'The Territorial Scope of the CCCTB' (CCCTB\WP\026\doc) 17 February 2006, p.4; European Commission, 'An overview of the main Issues that Emerged of the Second Meeting of the subgroup on International aspects (Working Document, CCCTB\WP\033\doc, 24 May 2006; European Commission, 'An overview of the main issues that emerged at the first meeting of the subgroup on international aspects (CCCTB\WP\092\doc) 2 March 2006.

<sup>543</sup> Arts.6 and 55 of the CCCTB Directive.

<sup>544</sup> European Commission, 'CCCTB: Possible of elements of a technical outline' (CCCTB\WP\057\doc\en, 26 July 2007), p.22.

The Commission had provided some possible structures of the group which are eligible for consolidation.<sup>545</sup> The main approach was for the CCCTB group to cover all entities located within the CCCTB Jurisdiction, even where the group is linked by non-EU companies. However, this was only allowed on the condition that the third country exchanged information on request to the standard of the Mutual Assistance Directive.<sup>546</sup> The rationale behind this condition was the elimination of expected double deduction in so-called ‘sandwich cases’, i.e. where a third country company was interposed between a parent company and its lower tier subsidiary and this company was located in a jurisdiction that does not exchange information on request to the standard of the Mutual Assistance Directive.<sup>547</sup> Under this approach, where a third-country company is interposed in a group structure without the existence of an exchange of information mechanism, the respective group formation would not be eligible for consolidation under the common rules.<sup>548</sup> However, the examples provided by the European Commission reveal that the existence of a third-country company as a link in the group formation does not seem to break the group, meaning that ‘sandwich cases’ could exist.<sup>549</sup>

Seemingly, the CCCTB Directive endorse the above stance, as it clarifies that a resident taxpayer will form a group with all the EU-permanent establishments of its *qualifying subsidiaries* which are resident in a third country. In contrast to what has been initiated by the European Commission (i.e. the availability of consolidation when the third country is involved requires an effective exchange of information), the CCCTB Directive does not mention the exchange of information either in the provisions of the qualifying subsidiaries or in the provision of formation of the group. Despite all the possibilities for the group structures given by the Commission,<sup>550</sup> it seems that the eligibility for consolidation when the subsidiaries or permanent establishments of a

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<sup>545</sup> European Commission, ‘Eligibility Testes for Companies and Definition of a CCCTB Group (CCCTB/RD\001), paras.14–18.

<sup>546</sup> *Ibid.*, para.17.

<sup>547</sup> European Commission, ‘Anti-Abuse Rules in the CCCTB’ (CCCTB/RD\004), paras. 25–26; for details on the Exchange of information in the CCCTB context see Maria Amparo Grau Ruiz, ‘Administrative Cooperation - Exchange of Information in the Context of the Common Consolidated Corporate Tax Base’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008),p. 945.

<sup>548</sup> European Commission, ‘Anti-Abuse Rules in the CCCTB’ (CCCTB/RD\004), para. 26.

<sup>549</sup> European Commission, ‘Eligibility Testes for Companies and Definition of a CCCTB Group (CCCTB/RD\001), paras.14–18.

<sup>550</sup> *Ibid.*, para.16.

third-country's qualifying subsidiaries are involved depends on the third-country being a co-operating one.<sup>551</sup> The question is raised as to whether the absence of the exchange of information condition in the CCCTB Directive can be a vitiating factor.<sup>552</sup> It is suggested that the provisions of anti-abuse rules provided in the CCCTB Directive are the main reason for not stipulating the exchange of information with the structures of the CCCTB consolidated group. In the following discussion, some scenarios of the CCCTB consolidated group's structures will be provided.

The first possibility for a group structure that involves third-countries entities is where there are two subsidiaries or more which are located in the EU and are controlled by a non-EU company, or where there is a non-EU entity which is undertaking business in the EU through an EU-resident parent and its subsidiaries including its permanent establishments. The question is whether the entities located in the EU should be eligible to form a group, and to be covered by the CCCTB system. In this case the answer is yes, in order to avoid tax planning, as the application of CCCTB can be avoided by moving the controlling parent company outside the EU.<sup>553</sup> However, the CCCTB Directive specifies that the third-country company must have a corporate form parallel to a listed EU corporate form.<sup>554</sup> Nevertheless, as the third-country entity itself will not be subject to the CCCTB system, it does not have to fulfil the eligibility test for the CCCTB, unless the third-country company will be subject to the CCCTB system regarding the tax base calculation rules and not subject to consolidation provisions.

The second scenario is when a resident taxpayer controls a non-EU subsidiary which in turn controls an EU-permanent establishment and subsidiaries.<sup>555</sup> The question that arises here is whether the CCCTB would cover the EU-parent company and its EU permanent establishments without taking into account the non-EU link. Having a non-EU link in ownership of an EU group does not break the chain.<sup>556</sup> The subsidiaries located in the EU which are wholly owned by a company located in third country are

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<sup>551</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.8.

<sup>552</sup> *Ibid.*

<sup>553</sup> European Commission, 'CCCTB: Possible of elements of a technical outline' (CCCTB/WP057/doc/en, 26 July 2007), p.22.

<sup>554</sup> Art.55 (1) (d) of the CCCTB Directive.

<sup>555</sup> Art.55 (b) of the CCCTB Directive.

<sup>556</sup> European Commission, 'CCCTB: Possible of Elements of a Technical Outline' (CCCTB/WP057/doc/en, 26 July 2007), p.23.

eligible to form a CCCTB group, but the third country where the controlling company is located should have an exchange of information agreement in place with the respective EU-Member State.<sup>557</sup> Otherwise there would be a scope of tax planning by relocating the intermediary or the link outside the EU to avoid the application of the CCCTB.<sup>558</sup> According to the legal criterion for the definition of a consolidated group, the required ownership threshold can be fulfilled directly or indirectly via subsidiaries.<sup>559</sup> Furthermore, in line with the neutrality principle, any two EU affiliates or more that are aligned through indirect ownership should form a group whether the intermediary is located in the EU or in a third country. Nonetheless, it is submitted that not taking the third country link into account does not support simplicity.<sup>560</sup>

Another possibility of the entities that are eligible for CCCTB consolidation is when a non-EU corporation controls an EU-subsiary which in turn is controlling the head of an EU group of companies, or when a non-EU company maintains a permanent establishment that controls EU-subsiaries.<sup>561</sup> The question in this case is whether the controlled EU group or the permanent establishment can be covered by the CCCTB. For the sake of neutrality the application of the CCCTB should be extended to affiliates located in the EU forming an economic integrated unit whether the controlling parent company is resident in the EU or in a third country. Otherwise an opportunity for tax planning would exist by moving the controlling entity to a third country.<sup>562</sup>

A final scenario for a consolidated group is when a third country has permanent establishments in two Member States or a permanent establishment and subsidiary in two Member States. The consolidation is extended to these permanent establishments and subsidiaries located in the EU regardless of the location of the parent company.<sup>563</sup> It should be stressed here that including subsidiaries that are controlled by a third country

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<sup>557</sup> European Commission, 'Eligibility Testes for Companies and Definition of a CCCTB Group (CCCTB/RD\001), p.6.

<sup>558</sup> European Commission, 'CCCTB: Possible of elements of a technical outline' (CCCTB/WP057\doc\en, 26 July 2007), p.23.

<sup>559</sup> Art.54 (1) of the CCCTB Directive.

<sup>560</sup> Carsten Wendt, *A Common Consolidated Corporate Tax Base for Multinational Enterprises in the EU* (Gabler, 2009, p.170.

<sup>561</sup> European Commission, 'CCCTB: Possible of elements of a technical outline' (CCCTB/WP057\doc\en, 26 July 2007), p.22.

<sup>562</sup> Art. 55(2) of the CCCTB Directive.

<sup>563</sup> European Commission, 'CCCTB: Possible of Elements of a Technical Outline' (CCCTB/WP057\doc\en, 26 July 2007), p.23.

in the CCCTB is consistent with OECD provisions. Article 24 (5) of the OECD Model on non-discrimination prohibits treating a subsidiary which is wholly or partly owned or controlled by a parent company of another country in a way which is other or more burdensome than the treatment of a similar subsidiary.<sup>564</sup> Therefore, discrimination should not exist between a subsidiary controlled by a non-EU-company and another one controlled by an EU-parent company, as long as they are located in the EU and have a relationship to another EU company that meets the requirements of the CCCTB. Therefore a subsidiary controlled by a non-EU Company is eligible for the application of CCCTB.<sup>565</sup>

Overall, all corporations resident in a Member State that is part of the regional group that has adopted the CCCTB system would be included in the water's-edge consolidation if they satisfy consolidation requirements, i.e. ownership and voting threshold as required by the CCCTB Directive. Foreign members of the corporation group would not be included in the water's edge consolidation. Nonetheless, EU-subidiaries and permanent establishments of foreign entities would be subject to consolidation. In other words, the CCCTB consolidated group is limited to the boundaries of the EU, but the third country intermediary does not break the chain of a group of companies.

### **3.4 Water's edge limitation in respect to income subject to consolidation and formulary apportionment**

Another issue to be addressed when analysing the limitation of the CCCTB water's edge, is the tax treatment of the foreign source income of the CCCTB corporations that are included in the consolidated group, i.e. whether the worldwide income of such entities should be consolidated or only their European-sourced income. The consolidated tax base will be subsequently apportioned according to the CCCTB formula apportionment. Thus, including or excluding foreign income raises the issue of the interaction between the CCCTB-formulary apportionment and the arm's length principle as a method for income allocation operating outside the CCCTB jurisdiction.

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<sup>564</sup> Art. 24(5) of the OECD Model Convention.

<sup>565</sup> Carsten Wendt, *A Common Consolidated Corporate Tax Base for Multinational Enterprises in the EU* (Gabler, 2009, p.171).

In order to define the CCCTB water's edge limitation in respect to income subject to consolidation and apportionment, four categories of income can be distinguished: income sourced in the EU by EU-based affiliates; income sourced outside the EU by third-country affiliates; income sourced in the EU by third-country-based affiliates, and income derived from third countries by EU-based affiliates.<sup>566</sup>

### **3.4.1 Income sourced in the EU by EU-based affiliates**

As established above, the water's edge of the 'CCCTB consolidated group' is limited to the boundaries of the EU. Thus, EU-sourced income made by EU-resident affiliates is eligible to accrue to the consolidated group for subsequent apportionment among the EU-Member States entitled to a share of it. This is because the CCCTB jurisdiction has a nexus with such income, i.e. source income.<sup>567</sup>

### **3.4.2 Income sourced outside the EU by third-country affiliates**

This category of income will not be included in the consolidated tax base, mainly as taxing rights fall away from the EU water's edge,<sup>568</sup> and the worldwide consolidation and formulary apportionment entails several difficulties such as incidence of double taxation and high administrative compliance obligations.<sup>569</sup> Consequently, the consolidated group in the EU will stay linked to its related entities in third countries or in non-CCCTB Member States by means of separate accounting under the arm's length principle. It is expected that the profit can be shifted away from the water's edge through the foreign entities. More specifically, in the short term, it has been found that limiting the contours of the consolidated group to the water's edge of the EU would reduce the profit-shifting opportunities that have been witnessed under the traditional

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<sup>566</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.20.

<sup>567</sup> William F. Fox, Matthew N. Murray, LeAnn Luna, 'How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?' *National Tax Journal*, Vol.53, No.1, 2005, pp. 139-159, at 143; for theoretical perspective on tax nexus see Walter Hellerstein, 'Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective', *Georgia Law Review*, Vol. 38 No. 1, 2003, pp.1-70.

<sup>568</sup> European Commission, 'The Territorial Scope of the CCCTB' (CCCTB\WP\026\doc\en, 17 February 2006), p.3.

<sup>569</sup> Michael Lang, et al, *Tax Treaties: Building Bridge between Law and Economics* (2010, IBFD), p. 191.



method for income allocation, i.e. separate accounting. However, in the long run, the profit-shifting outside the water's edge of the EU would increase if the domestic tax rate in Member States is set up high.<sup>570</sup> However, in this respect, confining the consolidation and formulary apportionment to the water's edge of the EU is considered to be beneficial because it is more likely to bring tax rates closer to the optimal point in the long term.<sup>571</sup>

Furthermore, some scholars have shown that transfer pricing manipulation among the other tax planning strategies would remain open where the consolidated group in the EU is connected to third countries via foreign companies.<sup>572</sup> Moreover, limiting the consolidation and formulary apportionment to the income of the members of a group resident in the EU raises an issue of tax planning in relation to third countries. Therefore, anti-avoidance rules will be required in order to protect the consolidated tax base.<sup>573</sup>

### **3.4.3 Income sourced in the EU by third-country-based affiliates**

As established above, foreign entities such as EU-located permanent establishments and *qualifying subsidiaries*<sup>574</sup> which are owned by third countries are included in the water's edge consolidation. Consequently, the income of these affiliates is consolidated and apportioned within the consolidated group as it is sourced in the EU. Therefore, the income of an EU-permanent establishment that is owned by a third country will be treated in the same way as the income of tax resident companies in a Member State.<sup>575</sup> Taxing the income of EU-permanent establishments is based on the notion that those non-resident entities have contributed to the integration of the group economies and

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<sup>570</sup> Nadine Riedel, Marco Runkel, 'Company Tax Reform with a Water's Edge', *Journal of Public Economics*, Vol.91, 2007, pp. 1533-1554 at 1553.

<sup>571</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.28.

<sup>572</sup> Gérard, M. 'Reforming the Taxation of Multijurisdictional Enterprises in Europe: A Tentative Appraisal' (2006) CESifo Working Paper No. 1795, p.3; Lodin and Gammie, M, 'Home State Taxation', (IBFD, 2001), p.54.

<sup>573</sup> McIntyre, Michael J., Paull Mines and Richard D. Pomp, 'Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana', *Louisiana Law Review*, Vol.61. 2001, pp.699-661, at 735.

<sup>574</sup> For definition of qualifying subsidiaries see Art. 54 of the CCCTB Directive.

<sup>575</sup> Art. 6(7) of the CCCTB Directive.

therefore to the group's overall EU distributable profits.<sup>576</sup> Excluding income of such entities would entail tax-avoidance using EU-operating foreign-based holding companies, and heavy transfer pricing documentation requirements for all transactions with their affiliates that reside in third countries.<sup>577</sup>

Nonetheless, the inclusion of such income raises issue of compatibility with current international tax rules that are based on the residence/ source concepts. For example, if the foreign affiliate is earning passive income, i.e. dividends, interest and royalties from a European source, the respective treaty provisions (equivalent to Arts. 10, 11 and 12 of the OECD Model), which limit the taxing right of the source country, would be infringed. This would occur where these types of income are included and taxed at a non-tax treaty rate. Moreover, as the EU-permanent establishment owned by a third country constitutes a substantial nexus in the EU, its income is consolidated and apportioned. However, this approach raises the issue of compatibility of formulary apportionment and current tax treaties standards, i.e. the arm's length principle. These issues will be analysed in depth in Chapter 5.

Under the CCCTB Directive, interest and royalties which are derived from the EU by a CCCTB *taxpayer* and paid to a recipient outside the group may be subject to withholding tax in the source Member State according to national rules and subject to applicable tax treaties. This implies that the CCCTB Directive does not provide for common rules regarding withholding taxes on outbound payments. If the company paying such income is a group member, the imposed withholding taxes are then shared among the rest of the group members according to the formula applicable in the tax year in which the tax is charged.<sup>578</sup> There is no equivalent provision for withholding tax on dividends.

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<sup>576</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.30.

<sup>577</sup> European Commission, 'The Design of an Apportionment Mechanism for an EU consolidated Tax Base' (2004) Discussion Paper DOC (4)1404, p.12.

<sup>578</sup> Art.77 of the CCCTB Directive.

#### 3.4.4 Income derived from third countries by EU-based affiliates

A typical pattern for this category of income is where an EU-parent company is operating in a third country through a permanent establishment or a subsidiary. The parent company may receive dividends, interest income, or royalties. The initial point of the treatment of foreign income could be the current tax practice in the national legislation of the Member States.<sup>579</sup> Worldwide taxation of a resident's income and source taxation of a non-resident's income are the most common approach currently applied in the EU. In contrast, the territoriality principle, under which both residents and non-residents are taxed on income derived only from the source of the country concerned, is followed by few Member States.<sup>580</sup> However, currently, tax rules concerning inbound payments differ to a substantial extent from one EU-Member State to another. Furthermore, considering the objective of the CCCTB as being to accommodate the increasing European economic integration, and the globalization of economic activities,<sup>581</sup> it can be said that the historic practice should not continue to affect the CCCTB tax policy towards third countries, i.e. the CCCTB should adopt *common rules on the tax treatment* of foreign income. In this respect, the question that arises is whether the CCCTB would tax the worldwide income of a tax resident, i.e. the foreign source income of a CCCTB group member, or whether it would adopt the source-based taxation principle, i.e. the inclusion or exclusion of the foreign income of a resident taxpayer.<sup>582</sup>

#### 3.4.5 Residence-based taxation or source-based taxation under the CCCTB

Importantly, the CCCTB scheme has to define its tax jurisdiction in relation to third countries or non-CCCTB Member States regarding the income that results from cross-border business activities. Mainly, there are two alternative approaches used by most

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<sup>579</sup> European Commission, 'International Aspects in the CCCTB' (CCCTB\WP\019\doc\en, 18 November 2005), p. 7.

<sup>580</sup> *Ibid.*, pp. 16-17.

<sup>581</sup> For more detail on principles regarding the treatment of foreign income see Michael P. Devereux, 'Taxation of Outbound Direct Investment :Economic Principles and Tax Policy Considerations', Oxford Review of Economic Policy ,Vol. 24, No. 4, 2008, pp. 698-719, at. 700.

<sup>582</sup> For the purpose of this research, the worldwide principle means the Taxation based on the source of income and/or the residence of the taxpayer in the respective territory, while the territoriality principle means the taxation due the source of the income in a territory.

countries to define their tax jurisdiction: residence-based taxation and source-based taxation. The US can be considered an exception to this rule, because it imposes taxes on the basis of citizenship in addition to the above alternatives.<sup>583</sup>

According to the source tax principle, which is referred to as the *territorial system*, foreign income obtained in the source country is taxed according to the taxation rules applicable in such country. This income is treated as tax exempted in the country of residence of the investor.<sup>584</sup> Pursuant to the residence-based taxation principle, the worldwide income of a resident investor is taxed according to the rules provided by the country of residence regardless of the jurisdiction where the income is generated. This system is known as the *worldwide taxation system*. Under this system, double taxation is avoided by granting credit for taxes paid in the source country.<sup>585</sup>

### ***Tax neutrality and efficiency***

Determining the CCCTB tax jurisdiction would depend on economic considerations such as economic efficiency, tax neutrality, competitiveness and the avoidance of double taxation.<sup>586</sup> Defining the tax jurisdiction of a certain country is mainly based on economic parameters<sup>587</sup>, meaning that taxation should be neutral. In order to achieve tax neutrality, the location of income generation factors should not be influenced by tax, or at least the effect of taxation should be minimised.<sup>588</sup> Similarly, economic efficiency can be achieved by neutralizing taxes. The business's decisions should be driven by market forces, not tax motives such as the modes of financing.<sup>589</sup> In other words, ownership and the legal form of the business entity should not be influenced by taxation, and thus an

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<sup>583</sup> Hugh J. Ault, Brian J. Arnold, Guy Gest, Peter Harris, 'Comparative Income Taxation: A structural analysis' (The Hague: Kluwer Law International, 2ed, 2004), p.347.

<sup>584</sup> Vogel, Klaus, Michael Engelschalk, Maximilian Gorl, Alexander Hemmerlath, 'Klaus Vogel on double tax conventions-A commentary to the OECD, UN and US Model Conventions for the avoidance of double taxation on income and capital with particular references to German treaties practices' (The Hague: Kluwer Law International, 3ed .ed., 1997), p.9.

<sup>585</sup> *Ibid*, p.10.

<sup>586</sup> Jeffrey Owens, 'Taxation within a Context of Economic Globalization', Bulletin for International Fiscal Documentation, Vol.52, No. 7, 2008, pp.290-296.

<sup>587</sup> *Ibid*, p. 291; Eric C.C.M. Kemmeren, 'Source of Income in Globalizing Economies: Over-view of the Issues and a Plea for an Origin-based Approach', Bulletin for International Taxation, Vol. 60, No.11, 2006, pp.438-441.

<sup>588</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008),p. 665.

<sup>589</sup> For definition of the concept of efficiency see Richard Abel Musgrave, Peggy B. Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill, 1989), p.60.

efficient allocation of resources would be promoted.<sup>590</sup> The allocation of the income generation factors to the location where they result in the highest return would maximise the efficiency of the international economy.<sup>591</sup> As regards the impact of taxation on the allocation of the income generation factors, the focus is commonly placed on capital movement.<sup>592</sup> In this respect the choice is drawn between Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).<sup>593</sup>

CEN means that the ‘*recipient* [of income] should pay the same total (domestic plus foreign) tax irrespective of whether he derives a given amount of investment income from foreign or from domestic sources’.<sup>594</sup> CIN is defined as ‘capital funds originating in various states [which] should compete on equal terms in the capital market of a state irrespective of the place of residence of the investor’.<sup>595</sup> Based on these definitions, it has been observed that the application of a residence based-taxation system with a credit for foreign tax achieves CEN. By contrast, CIN implies the application of a territorial tax system with exemption for foreign income.<sup>596</sup> The question is whether the CCCTB should be based on a source-based tax system and accordingly on CIN, or on a residence-based tax system and the CEN principle.<sup>597</sup>

### 3.4.5.1 Residence-based taxation

In principle, the residence-based taxation is supported on the ground that it is consistent with the ‘ability to pay’ principle. This includes the taxpayer’s worldwide income,

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<sup>590</sup> Krister Andersson, ‘An Economist’s view on Source versus Residence taxation- The Lisbon objective and taxation in the European Union’, *Bulletin for International Taxation*, October 2006, pp.395 ,398.

<sup>591</sup> Gary Clyde Hufbauer, Joanna M. Van Rooij, *U.S. Taxation of International Income: Blueprint for Reform* (Institute for International Economics, 1992), p.55.

<sup>592</sup> Alexander W. Cappelen, ‘National and International Distributive Justice in Bilateral Tax Treaties’, *FinanzArchiv*, Vol. 56, 1999, pp. 424-442, at 231.

<sup>593</sup> Michael Lang, et al, ‘*Tax Treaties: Building Bridge between Law and Economics*’ (2010, IBFD), p. 291.

<sup>594</sup> Vogel, Klaus, ‘worldwide vs. source taxation of income –a review and re-evaluation of arguments’ (part II) *Intertax*, Vol.310, No.10, 1988, p.311.

<sup>595</sup> *Ibid.*

<sup>596</sup> *Ibid.*

<sup>597</sup> Generally, it submitted that in the absence of a full harmonization of tax systems it is not realistic to achieve both CIN and CEN at the same time. At the EU level, the EU law currently does not provide a consistent tax neutrality concept as well. Both primary and secondary EU law do not give preference to CIN or CEN, see respectively Hugh J. Ault and Jacques Sasseville, ‘Taxation and Non-discrimination: A Reconsideration’, *World Tax Journal*, Vol. 2, No. 2, 2010, pp.101-125, at 102; Maarten F. de Wilde, ‘Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy’, *Intertax*, Vol. 38, No. 5, May 2010, pp. 281-305, at 300.

which reflects the taxpayer's international ability to pay.<sup>598</sup> In contrast, the source-based taxation is not compatible with the 'ability to pay' principle.<sup>599</sup> The residence-based taxation is preferred because it results in CEN,<sup>600</sup> i.e. all investors are taxed at their country of residence, regardless of where they earn their income. Moreover, where corporate tax rates differ between countries, the residence-based taxation would effectively achieve the objective of CEN. This is because the tax applicable to foreign income would equal the tax on domestic income, especially in capital-exporting countries.<sup>601</sup> Therefore the application of the worldwide taxation system is thought to serve tax neutrality.

In terms of efficiency, it is argued that the residence-based taxation system allocates the main income generation factors, especially capital, to the place where their productivity is the highest; however, this would happen when residence-based tax approach has a wide acceptance around the world. Source-based taxation, on the other hand, would lead to an inefficient allocation of economic resources as it discourages investment in a high-tax jurisdiction and encourages investment in low-tax jurisdictions.<sup>602</sup>

#### **3.4.5.1.1 Flaws of implementing a residence-based taxation approach**

Adopting a pure residence-based tax system has been questioned. Firstly, it would represent a radical change in taxing rights, which may imperil the existing allocation practice of tax revenues and revenue-sharing between source and residence countries. This might not be regarded as an equitable consequence for several countries, i.e. it would lack international support. Furthermore, if this approach was applied, unilateral measures could be invoked by many countries in order to preserve their tax base, which in turn would result in double taxation.<sup>603</sup> Moreover, under a pure residence-based tax, the worldwide tax base might be eroded as the risk of capital flight to low-tax jurisdiction increases. Capital flight refers to the decision of resident taxpayers to invest

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<sup>598</sup> Dale Pinto, 'Exclusive Source or resident-based taxation –is a new simpler world tax order possible?' Bulletin for International Taxation, July, 2007, pp. 277,280.

<sup>599</sup> Green, Robert, 'The Future of Source-based Taxation of Income of Multinational Enterprises', Cornell Law Review, Vol.97.No.18, 1993, p. 29.

<sup>600</sup> Dale Pinto, 'Exclusive Source or resident-based taxation –is a new simpler world tax order possible?' Bulletin for International Taxation, July, 2007, p. 277.

<sup>601</sup> *Ibid*, p. 280.

<sup>602</sup> McLure, Jr., Charles E., 'US Tax Laws and Capital Flight from Latin America' (1988) Working Paper in Economics E-88- 21, the Hoover Institution, Stanford University, p.7.

<sup>603</sup> Dale Pinto, 'Exclusive Source or resident-based taxation –is a new simpler world tax order possible?' Bulletin for International Taxation, July, 2007, p. 280.

abroad rather than domestically because of the possibility of low taxation in offshore jurisdictions.<sup>604</sup> Therefore, if the pure residence-based tax system applied in the CCCTB, anti-abuse rules such as the CFC ones would need to be implemented.

Another drawback of implementing a pure residence-based tax system is that the *test for determining corporate residence is used differently* by different countries. Such tests are vulnerable to manipulation. Hence, a reassessment of the current definition of residence and tax rules are required in order to determine whether an internationally acceptable and strict test for residence can be established so as to enable an exclusively residence-based system that can operate effectively. Therefore, an international consensus should be reached on a common test for residence to apply a pure tax residence approach.<sup>605</sup> Accordingly, if the worldwide taxation is adopted in the CCCTB, a common definition of tax residence would be necessary.

With regard to tax *neutrality*, generally the argument in favour of a residence-based tax system in achieving tax neutrality has been challenged; it has been argued that as a rule, considerations of efficiency and equity endorse source-based taxation in the source country.<sup>606</sup> More specifically, despite the view that the CEN and thus the worldwide taxation system would foster tax efficiency,<sup>607</sup> and would not disturb competition,<sup>608</sup> it is argued that taxation based on the worldwide principle creates a non-neutral and therefore insufficient system, due to the differences in the residence state taxation of the competitors of the relevant market. In other words, residents of high tax states will be deterred from investing in low tax states because the residents of low tax states, who have a higher after-tax return, will have a competitive advantageous position.<sup>609</sup> This outcome is in contrary to CEN policy.

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<sup>604</sup> Dale Pinto, 'Exclusive Source or resident-based taxation – is a new simpler world tax order possible?' Bulletin for International Taxation, July, 2007, p. 280.

<sup>605</sup> *Ibid*, p. 280.

<sup>606</sup> Vogel, Klaus, 'Worldwide vs. Source Taxation of income – A review and Re-evaluation of Arguments', part III, Intertax, No.11, 1988, p.393.

<sup>607</sup> David L. Forst, 'The U.S. International Tax Treatment of Partnership: A Policy Based Approach', Berkeley Journal of International Law, Vol.14, No.2, 1996, pp. 239, 242.

<sup>609</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) p.670.

At the EU level, particularly in the light of the *Lisbon Strategy objectives*, the alignment of the worldwide taxation principle with the CEN policy is questioned. If the European businesses are to compete in an open and worldwide economy, it is critical that they are able to function in foreign markets in conditions similar to those applicable to domestic competitors in those markets. By taxing income on a worldwide basis and relieving double taxation by means of credit, European countries are effectively exporting their often high tax levels to foreign markets. Subsequently, European businesses are challenged with more burdensome taxation than their domestic competitors. This disadvantage competitive position of European business firms will have a strong negative impact on their opportunities to benefit from new and important markets.<sup>610</sup>

It has also been suggested that CEN policy has critical results for the ownership structures of businesses and hence for the tax revenues of EU-Member States. The unequal competition between EU companies and third-country companies would lead, under a CEN policy, to the shift of *headquarters* to the low tax countries.<sup>611</sup> This would mean that parent companies could reduce the tax on their worldwide income by moving their legal residence from an (EU) high tax country to a low tax (third) country.<sup>612</sup> This prospect is likely to happen, especially in globalizing economies in which many enterprises are becoming more multinational.<sup>613</sup> Although the double taxation of business is partly alleviated in the context of residence-based taxation, it has another negative aspect, as it comes at the expense of huge compliance costs, demanding large resources from both taxpayers and tax administrations.<sup>614</sup>

#### **3.4.5.2 Source-based taxation**

Against the disadvantage of implementing the pure residence-based taxation, it has been thought that allocating tax jurisdiction based on the territoriality principle should

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<sup>610</sup> Krister Andersson, 'An Economist's view on Source versus Residence taxation- The Lisbon Objective and Taxation in the European Union', *Bulletin for International Taxation*, October 2006, pp.395,398.

<sup>611</sup> *Ibid.*

<sup>612</sup> OECD, 'Taxing Profits in a Global Economy: Domestic and International Issues' (Paris: OECD, 1991), p.179.

<sup>613</sup> Vito Tanzi, 'The Impact of Economic Globalisation on Taxation', *Bulletin for International Taxation* Vol.52, No. 8/9, 1998, p. 339.

<sup>614</sup> Krister Andersson, 'An Economist's view on Source versus Residence taxation- The Lisbon objective and taxation in the European Union', *Bulletin for International Taxation*, October 2006, pp.395,399.



prevail.<sup>615</sup> The source-based taxation approach enables enterprises to compete on a level playing field with their foreign competitors. As a result, a tax system based on the territoriality principle would contribute to an efficient allocation of the production factors not only within the EU countries but also at the international level.<sup>616</sup>

### ***Neutrality***

Since the endorsement of CEN or CIN depends on the features of a given economy,<sup>617</sup> CIN is more compatible with economies that are more open, since the EU's *policy must be conducted in accordance with the principle of an open market economy with free competition*.<sup>618</sup> Therefore, the choice of CIN is more consistent with the nature of the internal market than the CEN is. In other words, CIN supports free competition where CEN does not<sup>619</sup>.

Having the negative effects of worldwide taxation and CEN in mind, there is much to gain by shifting to a CIN policy. Firstly, CIN would provide a level playing field in relation to third countries, thus European businesses would be able to compete on equal footing. In line with the Lisbon objectives, economic efficiency – and eventually growth and jobs – would be enhanced. CIN would also work to retain and attract *head offices* to the EU rather than pushing out ownership in favour of third countries' investors.<sup>620</sup>

Generally, double tax conventions are seen as contributing to further opening of the economies of the countries involved, and as establishing a market between EU-Member States and the third countries with which the tax treaties are concluded that is similar to the internal market in the EU. In other words, double tax treaties create a lower-level internal market. This would promote free competition between the enterprises on both sides. The application of CIN is consistent with the nature of this lower-level internal

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<sup>615</sup> For rationales behind the trend towards territoriality see Reuven S. Avi-Yonah, 'Back to the Future? the Potential Revival of Territoriality', October 2008, *Bulletin for International Taxation*, October 2008, pp.471, 474.

<sup>616</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) p.673.

<sup>617</sup> *Ibid*, p.672.

<sup>618</sup> See Arts. 4(1) and 98 EC Treaties.

<sup>619</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) p.672.

<sup>620</sup> Krister Andersson, 'An Economist's view on Source versus Residence taxation- The Lisbon objective and taxation in the European Union', *Bulletin for international taxation*, October 2006,395 at 398.

market as the CIN underscores in the best possible way the operation of such a market by creating a level playing field, meaning that capital originating in the EU-Member States and double tax treaty countries would compete on equal terms in the capital markets of any state irrespective of the investor's place of residence.<sup>621</sup>

Furthermore, the adoption of a CIN policy would lead to considerable *simplification* and would eliminate double taxation. This would be particularly the case if countries were to abandon worldwide taxation in favour of a more territorial scheme. A wide spread of territoriality would considerably reduce the risk of double taxation and thus the application of complex and often inadequate rules against *double taxation*.<sup>622</sup> From a conceptual point of view, the source-based taxation principle seems compatible with the CCCTB because the income received from a third country would be tax exempt. The source tax principle does not imply an administrative cost despite the wide difference that results from applying formulary apportionment to the group companies in the CCCTB jurisdiction and separate accounting under the arm's length principle with a third country.<sup>623</sup> Nonetheless, it would provide an opportunity for profit shifting, mainly by manipulating transfer pricing rules.<sup>624</sup>

In addition, the precise application of the source-based taxation principle is not realistic from a practical point of view, as it is not consistent with the existing tax treaties. A source country has limited taxing rights, with certain kinds of passive income as royalties and interests under the OECD Model.<sup>625</sup> These kinds of income may be taxed in the country of residence and credited with tax paid in the source country to eliminate double non-taxation.<sup>626</sup> Finally, the meaning of the territorial tax system is unclear.<sup>627</sup>

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<sup>621</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008) p.672.

<sup>622</sup> Krister Andersson, 'An Economist's view on Source versus Residence taxation- The Lisbon objective and taxation in the European Union', *Bulletin for International Taxation*, October 2006, pp.395,399.

<sup>623</sup> Hellerstein and McClure, 'The European Commission Report on Company Income Taxation: What the EU can learn from the Experience of the US States', *International Taxation and Public Finance*, 2004, p. 207.

<sup>624</sup> Carsten Wendt, *A Common Consolidated Corporate Tax Base for Multinational Enterprises in the EU* (Gabler, 2009), p.91.

<sup>625</sup> *Ibid*, pp.183-184.

<sup>626</sup> Alex Easson, 'Common law approaches to the determination of the source of income: Pragmatism over principle', (2006), *IBFD*, pp.495, 500.

<sup>627</sup> Manfred Mosssner, 'Source versus Residence- an EU Perspective', *Bulletin for International Taxation*, December 2006, pp.501-506.

The argument above generally shows the preference for the source-based tax system in order for the CIN to be achieved. Therefore, with regard to the determination of the CCCTB tax jurisdiction in relation to third countries, it has been recommended that the CCCTB should be based on the *territoriality principle*.<sup>628</sup> It is suggested that the determination of CCCTB tax jurisdiction in relation to third countries should be based on criteria such as the elimination of double taxation, reduction of compliance cost, and keeping the conflict with the existing double tax convention with third countries to a minimum level.

#### **3.4.6 The CCCTB choice regarding tax treatment of foreign income: worldwide taxation in the CCCTB**

In so far as foreign income is concerned, the Commission had primarily considered two possibilities: either to exclude such income completely from the CCCTB, or to have it incorporated into the CCCTB and apply a consolidation and apportionment mechanism.<sup>629</sup>

At a later stage, the Commission adopted a midway approach, under which a distinction is made between foreign source income and EU-income.<sup>630</sup> Foreign source income received from major shareholdings and permanent establishments was to be tax exempt, subject to a switch-over to the credit method where the corporate tax rate in the source country is low. Portfolio dividends and other passive income were to be taxed with a credit for withholding tax paid. Both the tax and the cost of the credit would be shared by the Member States<sup>631</sup>

The Commission made a few changes and a number of clarifications. Three types of income were to be exempt from taxation; namely, received profit distributions (both

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<sup>628</sup> European Commission, Comments on CCCTB\WP\026, The Territorial scope of the CCCTB, p.3.

<sup>629</sup> See, for example European Commission 'International Aspects in the CCCTB' (CCCTB\WP\019\doc\en, 8/12/2005), p.3; European Commission 'Report and Discussion on Progress of the Sub-group on International Aspects' (CCCTB\WP\033\doc\en, 24/5/2006), p.2.

<sup>630</sup> European Commission, 'CCCTB: Possible of Elements of a Technical Outline' (CCCTB\WP\057\doc\en, 26 July 2007), para.20.

<sup>631</sup> *Ibid*, para.122.

portfolio dividends and direct investment), income from permanent establishments situated in third countries and proceeds from the disposal of shares outside the group.<sup>632</sup>

The CCCTB Directive has adopted the worldwide taxation principle, i.e. the inclusion of foreign income in the consolidated tax base.<sup>633</sup> The CCCTB taxing right is based on *residence-based taxation* which taxes resident taxpayers on their worldwide income and non-resident taxpayers on their income sourced in the EU through permanent establishments.<sup>634</sup>

Although the source-based taxation system, which supports CIN policy, is arguably favoured over residence-based taxation (as established above), the CCCTB Directive nevertheless adopted a worldwide tax approach, i.e. the inclusion of the foreign income in the consolidated tax base. Thus, the CCCTB Directive stance needs to be justified.

In principle, many experts point out that the endorsement of one alternative, either the worldwide taxation or the territoriality system, represents a fundamental element of the Member States' fiscal policy.<sup>635</sup> Therefore, a system that presupposes an obligatory switch to a different principle might limit the number of Member States interested in joining the CCCTB.<sup>636</sup> Since the worldwide taxation of residents' income is preferred to the territoriality principle in most Member States in the EU<sup>637</sup> it seems that the CCCTB favours worldwide taxation because it is a commonly applied principle. In other words, the conflict of the CCCTB rules with the current practice of Member States, and discrimination in relation to companies not participating in the CCCTB can be avoided. Moreover, the application of residence taxation results in a broad tax base.<sup>638</sup>

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<sup>632</sup> European Commission, 'Transactions and Dealings between the Group and entities outside the Group' (CCCTB/RD\003, 1 September 2010), para. 5.

<sup>633</sup> Art. 6(6) of the CCCTB Directive.

<sup>634</sup> (Art. 6(7) of the CCCTB Directive.

<sup>635</sup> Jérôme Montenegro, *Taxation of Foreign Business Income Within the European Internal Market* (IBFD 2012), p.71 et seq.

<sup>636</sup> European Commission, 'Progress to date and future plans for the CCCTB' (CCCTB\WP\046\doc\en), p.6.

<sup>637</sup> European Commission, 'An overview of the main issues that emerged at the first meeting of the subgroup on international aspects', (2 Mrch,2006,CCCTB\WP\doc\en,p.4.

<sup>638</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.23.

It was also pointed out that when the worldwide taxation approach is combined with the exemption method for eliminating double taxation, it produces similar results to the territoriality principle. In other words, the benefits of applying the territoriality principle can be achieved through the worldwide taxation of tax residents and source taxation of non-residents associated with the exemption of foreign income of tax residents.<sup>639</sup>

On the other hand, the exclusion of foreign income has some implications which are presumably meant to be prevented by the CCCTB Directive. The exclusion of foreign-sourced income from consolidation and apportionment and taxing it under the existing residence principle of the national legislation of the individual Member States implies the maintenance of different tax systems: consolidation and formulaic apportionment to distribute the EU-sourced income among Member States *and* the separate accounting system to be applied to third countries' income.<sup>640</sup> Thus, opting for keeping foreign income outside consolidation may increase tax compliance and administrative costs for the functioning of the whole system.<sup>641</sup> The inclusion of worldwide income also means the inclusion of worldwide losses, i.e. importing foreign losses into the CCCTB. However, this can be avoided if the worldwide income approach is applied in the CCCTB without excluding any subsidiary when the tax base of the consolidated group is calculated.<sup>642</sup>

Moreover, the exclusion of foreign income would require the introduction of an accounting system that allows a group corporation to differentiate between expenses related to EU income, i.e. the deductible expenses for the purposes of computing the consolidated tax base, and expenses linked to foreign income, i.e. deductible expenses from foreign gross income under the separate system. For instance, interest on debt acquired by an EU-parent company to fund equity investments in European and foreign subsidiaries would have to be extricated in order to allocate it as adequate for either of the two dissimilar systems. It goes without saying that the refinement in the attribution

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<sup>639</sup> European Commission, 'Progress to date and future plans for the CCCTB' (CCCTB\WP\046\doc\en), p.6.

<sup>640</sup> European Commission, 'The Design of an Apportionment Mechanism for an EU consolidated Tax Base' (2004) Discussion Paper DOC (4)1404, p.10.

<sup>641</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working paper No.9/2006,p.23.

<sup>642</sup> European Commission, 'an overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG4), (24 May, 2006, CCCTB\WP\033\doc\en), p.4.

of expenses to each category of income makes the application of the entire system more burdensome.<sup>643</sup>

In conclusion, the adoption of worldwide taxation and the inclusion of foreign income in the CCCTB is a more cost-efficient system and simpler than the exclusion of third countries' income. It would also be consistent with the very goal of the CCCTB, which is a common approach for all participant Member States. In other words, the CCCTB should either follow the territoriality principle or worldwide taxation. A divided system where some countries rely on one system and some on the other would create wide tax planning opportunities and would lead to insurmountable complexity.<sup>644</sup> Therefore, the CCCTB Directive has provided for a common approach, which is worldwide taxation. However, the worldwide taxation system would need a sufficient mechanism for double taxation elimination. Additionally, the common tax base will need to be protected against tax avoidance and tax erosion.

### **3.5 Transactions between the CCCTB consolidated group and other entities: implications of the water's edge approach**

Limiting the territorial scope of the CCCTB system to the water's edge of the EU has several implications. The first one is that the consolidated group will continue linked to its related entities outside the group via separate accounting under the arm's length principle. In this respect a distinction has to be made between the transactions involving entities outside the group but in the EU and those involving entities resident in third countries.

#### **3.5.1 Dealings within the consolidated group**

Under the CCCTB Directive, as a result of consolidation and formulary apportionment, there will be no withholding taxes or other source taxation to be imposed on transactions or payments of any kind between taxpayers or members of the same group.

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<sup>643</sup> European Commission, 'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options' (2006) Working Paper No.9/2006,p.26.

<sup>644</sup> European Commission (CCCTB WG) An overview of the main issues that emerged at the first meeting of the subgroup on international aspects ,2006,p.5.Also European Commission ,Comments on document CCCTB \WP\026 ,the Territorial scope of the CCCTB.

<sup>645</sup> Since the intra-group transactions are eliminated,<sup>646</sup> these transactions are not based on separate accounting and transfer pricing under arm's length anymore.

This removal of the transfer pricing formalities is considered a significant benefit of the CCCTB scheme.<sup>647</sup> The CCCTB Directive states that in computing the consolidated tax base, profits and losses arising from transactions directly carried out between members of a group should be ignored.<sup>648</sup> However, transactions between group members must be adequately documented in a consistent way, and the chosen method for recording intra-group transactions may only be changed for valid commercial reasons at the beginning of the tax year.<sup>649</sup> The method should enable all intra-group transfers and sales to be identified at the lower of cost or value for tax purposes.<sup>650</sup>

This means that the prices charged between members of a CCCTB group would no longer influence the final tax liability, and therefore the opportunities for taxpayers to manipulate these prices would no longer exist. Accordingly, the tax authorities would not have to make any transfer pricing adjustments under the arm's length principle. Alternatively, the tax bases of the group members would be consolidated and allocated on the basis of formulary apportionment.

### **3.5.2 Dealings between the consolidated group and other entities in non-CCCTB Member States**

A critical issue is the tax treatment of transactions between the consolidated group and related entities resident in non-CCCTB Member States and whether these are given the same treatment as dealings between the consolidated group and related entities in third countries. The importance of this question stems from the fact that all CCCTB-Member

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<sup>645</sup> Art. 60 of the CCCTB Directive.

<sup>646</sup> Art. 59 of the Council Directive.

<sup>647</sup> See the explanatory memorandum to the CCCTB proposal, it states that  
'A key obstacle in the single market today involves the high cost of complying with transfer pricing formalities using the arm's length approach. Further, the way that closely-integrated groups tend to organise themselves strongly indicates that transaction-by-transaction pricing based on the 'arm's length' principle may no longer be the most appropriate method for profit allocation.'

<sup>648</sup> (Art. 59(1)) of the CCCTB Directive.

<sup>649</sup> (Art. 59(3)) of the CCCTB Directive.

<sup>650</sup> (Art. 59(4)) of the CCCTB Directive.

States are equally concerned with the issues related to the design of the CCCTB, such as the substantive rules on determining the tax base, the eligibility criteria, the formula apportionment and its factors as well as administration and procedures. These issues would not raise problems between the CCCTB countries as the Directive provides for common rules on these matters. Nevertheless, non-CCCTB Member States would face more issues to be considered. In other words, the distinction between the CCCTB and non-CCCTB Member States touches upon critical issues. It is relevant to the tax treatment of inbound and outbound investments from and into the CCCTB group. It is also related to the interaction between separate accounting applicable to non-CCCTB Member States and formulary apportionment applicable within the consolidated group members.<sup>651</sup>

Since it is perceived that a mandatory CCCTB system is not consistent with the subsidiarity principle,<sup>652</sup> the CCCTB is intended to be optional rather than being mandatory, i.e. a corporate group can opt for the CCCTB if they consider that this tax system is beneficial, while the other companies which opt out will continue to apply their national tax systems.<sup>653</sup>

Moreover, the CCCTB proposal is based on Article 115 of the Treaty on the Functioning of the EU under which unanimity is required within Member States for adopting a Directive. Accordingly, at the Member States level it seems unrealistic to assume that all Member States will agree on the CCCTB. Unanimity is difficult to reach, given the hostility shown by several Member States, such as the UK, Czech Republic and Slovakia, which are mainly opposed to the proposal. This means that there will be non-CCCTB Member States even if the CCCTB proposal is adopted under ‘*enhanced cooperation*’ as has been already announced by the EU Commissioner Algirdas Semeta.<sup>654</sup> Seemingly, there would be CCCTB entities and non-CCCTB entities within the EU-Member States. This in turn raises the question of whether third

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<sup>651</sup> Malcolm Gammie, Christiana Panayi, Inbound Investment and Thin Capitalization’, in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base*, (Linde, 2008),p.832

<sup>652</sup> Memo of the CCCTB Directive, p.9.

<sup>653</sup> Art.7 of the CCCTB Directive.

<sup>654</sup> Margarida Vasconcelos, ‘EC Takes One more Step towards Tax Harmonization’, Bill Cash’s European Journal, 18/ March/2011, at < [http://www.europeanfoundation.org/my\\_weblog/2011/03/one-step-towards-tax-harmonisation.html](http://www.europeanfoundation.org/my_weblog/2011/03/one-step-towards-tax-harmonisation.html)> accessed 20 February 2013.



countries and non-CCCTB Member States are treated equally under the CCCTB system.

The answer to this question can be inferred from the provisions of the CCCTB Directive. The CCCTB Directive states that ‘the provisions of this Directive shall apply notwithstanding any provision to the contrary in any agreement that [is] concluded between EU Member States’. This means that the CCCTB Directive overrides the conflicting provisions in any agreements concluded between Member States.<sup>655</sup> Moreover, when an eligible company opts for the CCCTB system, it will cease to apply the national corporate tax system with regard to all arrangements that are regulated by the CCCTB Directive.<sup>656</sup> This reflects the prevalence of the Community law over bilateral treaties between Member States in the same way as it overrides national law in the EU in general. Thus, it could be argued that even non-CCCTB Member States would still come under the obligations of the Community law to respect the CCCTB rules, and to adapt to the Directive provisions, i.e. they would be in a different position from that of third countries.<sup>657</sup> It can be said that the CCCTB Directive can be adopted under *enhanced cooperation*, and it would not bind non-participating Member States.<sup>658</sup> Nevertheless, non-participating Member States are under a duty not to impede the CCCTB implementation.<sup>659</sup> The enabling provisions of the EU Treaties do not delimit the extent of this duty of non-impediment. Although the scope of the obligations of the non-participating Member States is currently unclear, the duty of non-impediment supported by the general duty of EU loyalty has become more effective.<sup>660</sup>

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<sup>655</sup> See Art. 8 of the CCCTB Directive; European Commission, ‘CCCTB: Possible of Elements of a Technical Outline’ (CCCTB/WP057\doc\en, 26 July 2007), in footnote 37; European Commission, ‘an overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG4), (24 May, 2006, CCCTB\WP\033\doc\en), para.3.

<sup>656</sup> See Art. 7 of the CCCTB Directive.

<sup>657</sup> Malcolm Gammie, Christiana Panayi, Inbound Investment and Thin Capitalization’, in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base*, (Linde, 2008),p.832.

<sup>658</sup> Art. 330 of TFEU.

<sup>659</sup> Art. 327 of TFEU.

<sup>660</sup> Christiana HJI Panayi, ‘The Common Consolidated Corporate Tax Base and the UK Tax System’ (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.63.

Despite the fact that non-CCCTB Member States are in a different position to that of third countries from a European law perspective,<sup>661</sup> the European Commission did not consider such a difference.<sup>662</sup> In other words, it did not distinguish between third countries and non-CCCTB Member States in respect to tax treatment of cross-border business activities. Similarly, the CCCTB Directive does not provide any distinct provisions for tax treatment cross-border business activities into and out of the CCCTB jurisdiction but within the EU. The CCCTB Directive<sup>663</sup> explicitly states that withholding taxes and other source taxation on payments, especially interests and royalties made by a taxpayer to a non-taxpayer outside the group whether it is EU-resident or not, will continue to be subject to the withholding taxes pursuant to the existing national tax laws and tax treaties. Moreover, with regard to inbound payments to the consolidated group, received profit distributions are exempt and other passive income is by default consolidated without differentiating between the income source, whether third countries or non-CCCTB Member States.<sup>664</sup>

The CCCTB Directive's stance is to some extent justifiable, given that the Commission assumes that all Member States will take part in the CCCTB.<sup>665</sup> Therefore, if the outcome of the consultation procedures of the CCCTB Directive results in the existence of non-CCCTB Member States, then non-CCCTB Member States have to be acknowledged by the Commission and distinct rules may be required. Special provisions on the treatment of non-CCCTB Member States will be required because the current proposed Directive overrides the tax treaties between CCCTB Members, but is silent about the tax treaties between the CCCTB Member States and non-CCCTB Member States. Moreover, if profit distribution such as dividends<sup>666</sup> and other passive

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<sup>661</sup> Generally, it is concluded that the EU law has a significant influence on the international tax systems of the EU-Member States, see Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', *Intertax*, Vol. 38, No. 5, May 2010, pp. 281-305, at 288.

<sup>662</sup> For example the ECJ ruled that 'although direct taxation is a matter of the Member States, the powers retained by the Member States in this respect must nevertheless be exercised consistently with Community law', see ECJ C-279/93 *Finanzamt Köln-Altstadt vs. Roland Schumacker* [1995] ECR I-00225, para.21; see also ECJ C-246/89 *Commission v United Kingdom* [1991] ECR I-4585, para. 12.

<sup>663</sup> See Art.77 of the Council Directive.

<sup>664</sup> This can be inferred from Arts. 11 and 57(1) of the CCCTB Directive.

<sup>665</sup> See generally European Commission, 'CCCTB: Possible Elements of a Technical Outline' (CCCTB/WP057/doc/en, 26 July 2007); European Commission, 'Transactions and dealings between the Group and entities outside the Group' (CCCTB/RD\003, 1 September 2010).

<sup>666</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline' (26 July 2007, CCCTB/WP057/doc/en), para.122.

income<sup>667</sup> are derived from non-CCCTB Member States, and are taxed in a similar way to third country income, the obligations of the non-CCCTB Member States under the EU law might be infringed. However, since the CCCTB Directive generally does not distinguish between non-CCCTB Member States and third countries,<sup>668</sup> it is more likely that non-CCCTB Member States would receive the same treatment as third countries. Accordingly, this research will proceed on such a basis, as established in the CCCTB Directive.

### **3.5.3 Dealings between the CCCTB group and other entities in third countries**

Unlike the transactions within the consolidated group, the transactions between the CCCTB consolidated group and other entities in third countries would be regulated by different rules. This is mainly because the scope of the consolidated group is limited to the water's edge of the EU. Firstly, the entities resident in third countries are not eligible to form part of the consolidated group. Despite the fact that the delineating of the consolidated group is based on legal criteria (ownership and voting rights), which do not give rise to excessive tax planning, the opportunities for tax planning can nevertheless arise by virtue of the formation of the consolidated group, as in most cases the consolidated group is linked by non-EU companies.<sup>669</sup> Therefore, anti-abuse rules have to be applied in relation to third countries.<sup>670</sup> These rules should include specific anti-avoidance rules such as CFC and thin capitalization.<sup>671</sup> Taxing the worldwide income of a CCCTB taxpayer requires a set of common rules for the elimination of the double taxation which would result from the overlap between the CCCTB tax jurisdiction and other countries' tax jurisdiction.

A critical impact for the limitation of water's edge is the transfer pricing issue. In other words, as a result of limiting the contours of the consolidated group and formulary apportionment to the water's edge of the EU, transactions between the CCCTB group

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<sup>667</sup> See Art. 76 of the CCCTB Directive.

<sup>668</sup> See Art. 76 of the CCCTB Directive.

<sup>669</sup> Lodin/Gammie, *Home State Taxation* (Amsterdam, 2001), p.41.

<sup>670</sup> European Commission, 'Eligibility Tests for Companies and Definition of a CCCTB Group' (CCCTB/RD\001\doc\en, 30 August 2010), para. 17.

<sup>671</sup> Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold, Jacques Sasseville, Eric M. Zolt (eds.) *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation 2003), pp.91-95.

and related entities outside the group, either in third countries or non-CCCTB companies in a Member State, are based on transfer pricing under the arm's length principle.<sup>672</sup> This is because a related party's transactions will not be restricted to members of a CCCTB group. For instance, transactions may be carried out between the consolidated group and the following related parties: firstly, related companies in third countries. There could never be consolidation and elimination of intra-group transactions between consolidated companies and related companies in third countries. Hence, separate accounting and the OECD Transfer Pricing Guidelines would still be applicable for dealings between these entities.<sup>673</sup> Secondly, related EU-companies that have not opted to apply the CCCTB system. Transfer pricing may still be relevant to them, even if they are within the same Member State, and therefore the CCCTB will create a border within a Member State, for transfer pricing purposes.<sup>674</sup> Thirdly, related EU companies that have opted to apply the CCCTB system but that are not sufficiently closely related to belong to the same group. The latter situation can arise because of the difference between the threshold for group membership and the lower-related party (or associated enterprise) threshold adopted by the Directive for the application of the transfer pricing rules.<sup>675</sup>

Transactions amongst these associated enterprises in the previous cases will be subject to pricing adjustments and corresponding adjustments under the arm's length principle. These would include transactions between CCCTB-group companies and third country group companies as well as between CCCTB-companies and non-CCCTB EU groups, which means that the non-CCCTB Member States are treated the same as third countries in this respect.<sup>676</sup> The CCCTB Directive's transfer pricing rules, like the other CCCTB provisions affecting the common tax base, replace the corresponding domestic Member State rules.<sup>677</sup> The CCCTB contains the transfer pricing rules.

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<sup>672</sup> See Art. 79 of the Council Directive; Joann Martens Weiner, *'Formulary Apportionment and Group Taxation in the EU: Insights from the United States and Canada'* (Springer 2006), p. 73.

<sup>673</sup> This can be distilled from Arts. 72 to 77 of the CCCTB Directive.

<sup>674</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.22.

<sup>675</sup> See Arts. 54 and 78 of the CCCTB Directive.

<sup>676</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.23.

<sup>677</sup> (Art. 7 of the CCCTB Directive.

### **3.5.3.1 Arm's length principle under the CCCTB**

Generally, the CCCTB Directive provides for the arm's length principle,<sup>678</sup> even though no explicit reference is made to the OECD Model, because not all Member States participate in the OECD and the Directive goes further than the OECD Model.<sup>679</sup> The arm's length principle in the CCCTB system uses the same wording as that of the OECD Model Convention, i.e. it allows an increase in profits where the conditions imposed between the associated enterprises differ from what would be applicable between independent parties. There is no provision for a decline in profits based on the arm's length principle. Unlike the OECD Model, there is also no provision for secondary adjustments.

### **3.5.3.2 Definition of associated Enterprises**

Since the associated parties are compelled to keep conditions and transactions carried out between them, in their commercial or financial relations, at arm's length,<sup>680</sup> a common definition of an associated enterprise is necessary in the CCCTB project.

The CCCTB Directive defines associated enterprises as follows:

'If a taxpayer participates directly or indirectly in the management, control or capital of a non-taxpayer, or a taxpayer which is not in the same group, the enterprises shall be regarded as associated enterprises.'

If the same persons participate directly or indirectly in the management, control or capital of a taxpayer and a non-taxpayer, or of taxpayers not in the same group, all the companies concerned shall be regarded as associated enterprises'.<sup>681</sup>

This definition is in principle in line with the OECD Model on the definition of related parties.<sup>682</sup> However, the CCCTB is seeking a wider degree of commonality than the

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<sup>678</sup> Art. 79 of the CCCTB Directive states that :

'where conditions are made or imposed in relations between associated enterprises which differ from those that would be made between independent enterprises, then any income which would, but for those conditions, have accrued to the taxpayer, but, by reason of those conditions, has not so accrued, shall be included in the income of that taxpayer and taxed accordingly'

<sup>679</sup> European Commission, (CCCTB/RD\003), para.17.

<sup>680</sup> European Commission, 'Related Parties in the CCCTB', (5 December 2006, CCCTB\WP\041\doc\en), p.2.

<sup>681</sup> See Art. 78(1) of the CCCTB Directive.

OECD, and also seeking common rules to be applied by the Member States participating in such system. Thus, a detailed definition of associated enterprises is required. Unlike the OECD, the details of what is meant by direct or indirect participation in the management control or capital is not left to the domestic legislation of the Member States.<sup>683</sup>

With regard to the definition of control and participation in the capital and management, it appears that the CCCTB Directive has avoided the case-by-case approach in favour of fixed thresholds. The CCCTB defines control as a holding exceeding 20% of the voting rights, participating in capital means a right of ownership greater than 20% of the capital, and participation in management means that the holding taxpayer exercises a definite influence in the management of the associated enterprise.<sup>684</sup>

Concerning the specific influence or control exercised by an individual, it is necessary to assign the same consequences when family members are involved. Thus, the CCCTB Directive clarifies that the influence or control exercised by the spouse and lineal ascendant and descendant has the same effect as if it were exercised by the individual himself or herself, meaning that the Directive regards them as a single person.<sup>685</sup>

In calculating indirect participation, the required threshold in respect to control and capital will be fulfilled by multiplying the rates of holding through the successive tiers. A taxpayer holding more than 50% of voting rights will be deemed to qualify as having a holding of 100%.<sup>686</sup>

### **3.6 The necessity of common definitions under the CCCTB**

Another important issue to be analysed in designing the CCCTB territorial scope is to define a company's residence and the presence of a permanent establishment. The current tax practice of the Member States can be invoked in this respect. Nonetheless, there is a disparity between Member States regarding the definitions established by

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<sup>682</sup> Art.9 of the OECD Model Tax Convention.

<sup>683</sup> European Commission, 'Related Parties in the CCCTB', (5 December 2006, CCCTB\WP\041\doc\en), p.14.

<sup>684</sup> Art.78 [2 (a), (b), (c)] of the CCCTB Directive.

<sup>685</sup> Art.78[2 (d)] of the CCCTB Directive.

<sup>686</sup> Art.78(2) of the CCCTB Directive

domestic tax law and tax conventions.<sup>687</sup> This diversity could give rise to definition manipulation. For instance, a parent company resident in a third country could situate its subsidiary in a Member State that applies a narrow definition of company's residence in order to stay out of the CCCTB scope. Moreover, if the permanent establishment and corporation's residence are defined differently, this would undermine the very objective of the CCCTB of having a common system that reduces compliance costs. Consequently, common definitions of tax residency and permanent establishment are necessary in the CCCTB.<sup>688</sup>

### 3.6.1 Definition of permanent establishment

In fact, providing a common definition on permanent establishment would have certain implications. It would be related to the tax treatment of permanent establishment income located in third countries (exempt or included in the CCCTB). The consolidation of non-resident income requires the presence of permanent establishment in the EU, i.e. the income of EU permanent establishment which is subject to consolidation and formulary apportionment, this also require defining permanent establishment<sup>689</sup>

The CCCTB Directive provides a detailed definition of permanent establishment. This definition largely follows Art. 5 of the OECD Model, which makes the role of the OECD clear in the CCCTB.<sup>690</sup> Unlike the Interest & Royalties Directive, the CCCTB Directive did not provide a definition that strictly follows Art. 5 of the OECD Model.<sup>691</sup> In addition, the CCCTB did not follow the Parent-Subsidiary Directive approach under which the permanent establishment is defined briefly along with a 'subject to tax' clause.<sup>692</sup> The CCCTB did not strictly adopt Art.5 of the OECD Model.<sup>693</sup> In other

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<sup>687</sup> European Commission, International Aspects in the CCCTB' (18/11/2005, CCCTB\WP\019\doc\en),p.7.

<sup>688</sup> European Commission, 'An overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG4), 24 May, 2006, CCCTB\WP\033\doc\en),pp.4-5.

<sup>689</sup> Arts. 55, 6(7) of the CCCTB Directive.

<sup>690</sup> Art. 5 of the CCCTB Directive.

<sup>691</sup> European Commission, 'An overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG4), 24 May, 2006, CCCTB\WP\033\doc\en),p.4.

<sup>692</sup> Art.2 (b) of Parent Subsidiary Directive.

<sup>693</sup> For detailed discussion on the permanent establishment definition according to the OECD Model see Ekkehart Reimer, Nathalie Urban, Stefan Schmid, *Permanent Establishments: Domestic Taxation, Bil*, (Kluwer Law International 2011), p.10 et seq.

words, it regulates that ‘a taxpayer shall be considered to have a “permanent establishment” in a state other than the state in which its central management and control is located when it has a fixed place in that other state through which the business is wholly or partly carried on ..’. Notably, the expression ‘*in a state other than the state in which its central management and control is located*’ constitutes an addition to the OECD Model definition of permanent establishment, which can be seen as purposeless. This expression makes the definition appear as if it is drafted so as to refer only to *permanent establishments* within a Member State.<sup>694</sup> Moreover, the CCCTB Directive does not contain any provision on the income attribution to a permanent establishment. Therefore, it is necessary for the Member states opting for the CCCTB system to share a common interpretation with regard to certain situations provided in the OECD Model.<sup>695</sup> In this respect, the principle applicable in connection with Art.7 of the OECD Model could prevail.

According to what has recently been approached by the OECD, transactions between permanent establishments and their head offices are regarded as being between independent enterprises.<sup>696</sup> The CCCTB Directive considers the relation between a head office and its permanent establishments located in a Member State or in a third country as a relation between associated enterprises.<sup>697</sup> However, this implies that the transactions between a permanent establishment and its headquarters will be priced at arm’ length.<sup>698</sup>

The concept of permanent establishment is criticised for being inconsistent with the characteristics of current economies. There is a wide difference between the natures of economies now and when the concept of permanent establishment was first established. For example, the history of Art.7 of the OECD Model on attributing income to a permanent establishment dates back to the 1920s.<sup>699</sup> The increasing importance of intangible assets and services constitutes a considerable part of today’s economies,

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<sup>694</sup> Art.5 (1) of the CCCTB Directive

<sup>695</sup> European Commission, ‘an overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG4), (24 May, 2006, CCCTB\WP\033\doc\en), p.4.

<sup>696</sup> European Commission, ‘Transaction and dealing between the group and entities outside the group, (CCCTB\RD\003\doc\en), p.6.

<sup>697</sup> Art.78 (1) of the CCCTB Directive.

<sup>698</sup> Art.79 of the CCCTB Directive.

<sup>699</sup> Michael Kobetsky, ‘Article 7 of the OECD Model: Defining the Personality of Permanent Establishment’ (2006) Bulletin for International Taxation, October 2006, pp.411-425, at 424.



being mainly based on knowledge. Moreover, in this respect human activities play a large part in today's economies. Therefore it is believed that an alternative for the concept of permanent establishment should be sought.<sup>700</sup> It is believed that the replacement of the concept of permanent establishment by an alternative that considered human activities to be an essential element for allocating tax jurisdiction should be adopted in the CCCTB Directive. This could motivate the OECD to reconsider the permanent establishment principle as an accepted principle in the double tax treaties.<sup>701</sup>

### 3.6.2 Definition of tax resident in the CCCTB

In principle, the distinction between a resident and non-resident taxpayer is critical in terms of worldwide taxation. This is because the nexus between the taxable income and the taxing jurisdiction is based on the residency of the taxpayer. The tax residence rules are commonly provided by the domestic laws of the Member States. However, when there is a conflict as a result of dual residence, a 'tie breaker' rule is provided by the relevant tax convention. Incorporation, registered office and the place of effective management are the most common criteria currently used for defining tax residence. The place of effective management is the most common criterion incorporated in the tax treaties with regard to dual residence.<sup>702</sup>

Adopting the worldwide taxation of tax residents in the CCCTB jurisdiction and taxing EU permanent establishments of companies resident in third countries on the same basis makes it desirable to define tax residency in the CCCTB. It is also necessary to determine the tie breaker rule as well, particularly from a long term perspective. Moreover, the definition of tax resident is mainly imperative for the purpose of opting for the CCCTB system, as doing so is based on the residency criterion.<sup>703</sup>

Under the CCCTB Directive, a company which has its registered office, place of incorporation or effective management in a Member State will be considered resident

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<sup>700</sup> Eric C.C. M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major Shareholdings' in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), pp. 686,689.

<sup>701</sup> *Ibid.*

<sup>702</sup> European Commission, 'International Aspects in the CCCTB' (18/11/2005, CCCTB\WP\019\doc\en), p.8.

<sup>703</sup> Art. 6 of the CCCTB Directive.

for tax purposes in that Member State.<sup>704</sup> Unlike the Interest and Royalties Directive and the Parent-Subsidiary Directive, the residence criteria are based on Union law, without any reference to domestic law.<sup>705</sup> This definition is not identical to Art.4 (1) of the OECD Model; the latter does not mention the registered office and place of incorporation criteria, and merely refers to the place of management and not the effective management. It is suggested that the CCCTB Directive should rely upon the existing expression for defining corporation residency in order to avoid interpretation disparity.

The CCCTB proposed Directive also contains a tie breaker rule. In the event that a company is deemed to be a tax resident in more than one Member State, pursuant to the criteria provided in the CCCTB Directive it will be considered to be a tax resident in the Member State in which it has its place of effective management.<sup>706</sup> This substitute rule does not vary from the one which is commonly used in the Member States' legislations or the one that is included in the tax treaties between Member States.<sup>707</sup> It should be highlighted that the purpose of this tie breaker rule is to resolve a conflict between two Member States. However, it is not workable in relation to third countries, as the tie breaker rule in this case is incorporated in the tax treaties concluded with third countries.

Moreover, the CCCTB Directive provides an additional criterion to determine a company's residence. Where a company is not, under an agreement concluded between a Member State and a third country, regarded as a tax resident in that third country, it will be considered as a tax resident in that Member State. In other words, if a company is considered to be a tax resident in a Member State according to the criteria mentioned in the CCCTB Directive, and at the same time is deemed to be a tax resident in a third country pursuant to a tax treaty concluded between that Member State and the third country, the tax treaty will prevail over the CCCTB provision, and therefore the company will be regarded as a tax resident in the third country.<sup>708</sup> As a result, Member

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<sup>704</sup> Art. 6(3) of the CCCTB Directive.

<sup>705</sup> Council Directive, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States', COM (2011) 714 final, Art. 2(c), (ii).

<sup>706</sup> Art 6(4) of the CCCTB Directive.

<sup>707</sup> European Commission, 'International aspects in the CCCTB' (18/11/2005, CCCTB\WP\019\doc\en), p.9.

<sup>708</sup> Article 6 (3) of the CCCTB Directive.

States will be allowed in this case to derogate in order to fulfil the obligations under double tax treaties with third countries.

### **3.7 Conclusion**

This chapter examined the territorial scope of the CCCTB system in relation to third countries, and the consequences of limiting the CCCTB scope to the water's edge of the EU. It shows that limiting the scope of the consolidated group to the water's edge of the EU, and hence excluding third country entities from consolidation, is justifiable, based on the US experience. This is compatible with the setting in the EU market, as the choice of worldwide consolidation is far reaching at least in the current stage. The choice of water's edge in respect to the entities eligible for the CCCTB is adequate because it constitutes a clear common policy towards third countries, and it is consistent with the territoriality principle and CIN policy. However, it has been shown that the common tax base will need to be protected against tax planning, due to the interaction between formulary apportionment and separate accounting in third countries, as the European group could shift profits and investments to non-EU countries. In this respect, the CCCTB needs also to examine how to coordinate those two different approaches.

It has been established that the CCCTB Directive adopted a residence-based taxation principle in respect to the foreign income of resident taxpayers. Although this approach is not supported by the commentators, because it is inconsistent with the CIN policy, the current feature of the Internal Market nevertheless justifies residence-based taxation. As the CCCTB Directive taxes the worldwide income of resident taxpayers in the CCCTB jurisdiction, double taxation would occur due to the overlap between the CCCTB tax jurisdiction and the tax jurisdiction of the third countries. Thus, international double taxation in respect to cross-border business activities vis-a-vis third countries will need to be abolished. Moreover, the CCCTB tax treatment of cross-border activities in third countries would have an impact on relevant provisions that are incorporated into the existing bilateral tax treaties between the CCCTB-Member States and third countries.

The CCCTB Directive provides for common definitions such as associated enterprise, permanent establishment and company residence. It is established that providing common definitions would alleviate tax-avoidance which could take the form of

artificial income shifting out of the EU into jurisdictions that apply low tax rates. The consequences of the limitation of the consolidation and formulary apportionment mechanism to the water's edge of the EU will be analysed in the next chapter. These include the need for the elimination of double taxation and the protection of the consolidated tax base in relation to third countries.

## **4 The CCCTB's Framework for the Avoidance of Double Taxation and for the Protection of the Common Consolidated Tax Base**

### **4.1 Introduction**

Taxing the worldwide income of a resident taxpayer in the CCCTB jurisdiction would inevitably result in international double taxation, normally because of the simultaneous application of residence-based taxation in the CCCTB jurisdiction and third countries, or due to the overlap between residence-based taxation in the CCCTB and source-based taxation in third countries.<sup>709</sup> In this respect, the CCCTB Directive unilaterally provides common rules for double taxation relief with regard to income derived by residents from third countries. A combination of the credit method and the exemption method, (which is associated with a switch-over clause), is outlined in the CCCTB system. Moreover, as concluded in the previous chapter, limiting the consolidation mechanism to the EU water's edge gives opportunities for tax planning and income-shifting outside the territorial scope of the CCCTB consolidated group. In order to protect the consolidated tax base, the CCCTB introduces common anti-abuse rules including GAAR, and specific anti-avoidance ones, such as the CFC rules and thin capitalisation rules. However, the unilateral common rules for double taxation avoidance and dedicated rules for the protection of the common tax base have a tax treaties dimension, i.e. they are likely to contradict the existing tax treaties with third countries.

To this end, this chapter examines how international double taxation in the context of the CCCTB can be avoided. To do so, the tax treatment of cross-border business activities, i.e. inbound and outbound investment between the potential CCCTB-Member States and third countries, will be delineated. This chapter argues that the CCCTB approach on double taxation avoidance is adequate. It also endeavours to answer the question of whether the common tax base is efficiently protected against tax erosion. In this regard, it is essential to analyse the main features of both GAAR and the specific anti-abuse rules as provided in the CCCTB Directive. The chapter argues that the CCCTB anti-abuse measures have the merit of protecting the common tax base. In the

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<sup>709</sup> See Mogens Rasmussen, *International Double Taxation* (Kluwer Law International 2011), p.1 et seq; Commentary on Article 23 A and B OECD 2010 Preliminary Marks, para. 3.

process of answering these questions, the areas in which the CCCTB rules may contradict the current tax treaties with third countries will be briefly highlighted for later discussion.

#### **4.2 The optimal function of the European Internal Market with third countries' economies requires the elimination of double taxation in the context of the CCCTB**

In principle, the existence of double taxation represents a serious obstacle to the development of the economic relations between countries; it has harmful effects on the exchange of goods and services and the movement of capital, technology and persons.<sup>710</sup> At the EU level, there is an objective of preventing double taxation in order to abolish its negative effects on the functioning of the internal market. In other words, the optimal function of the internal market requires the elimination of double taxation. This objective is consistent with Article 26(2) of the TFEU which defines the internal market as an area with no obstacles to the free movement of goods, services, persons and capital. In addition, several rulings of the ECJ have endorsed the elimination of double taxation in the Internal Market.<sup>711</sup> Therefore, it is submitted that preventing double taxation, and consequently promoting the smooth function of the Internal Market, is a part of EU law,<sup>712</sup> and is evident in many of the ECJ's decisions.<sup>713</sup> Eventually, the CCCTB, as a comprehensive approach, would eliminate the double taxation within the consolidated group but without the need to conclude any tax treaties between the participant Member States, thanks to the consolidation approach.<sup>714</sup> Thus,

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<sup>710</sup> Introduction of the commentary on the OECD Model Convention, 2010, para.1.

<sup>711</sup> ECJ C-513/04, *Mark Kerckhaert, Bernadette Morres V Belgische Staat* [2006] ECR I-10967, para. 21, it has been ruled that, 'conventions preventing double taxation such [...] are designed to eliminate or mitigate the negative effects on the functioning of the internal market resulting from the coexistence of national tax systems'; see also ECJ C-298/05, '*Columbus Container Services BVBA & Co V Finanzamt Bielefeld-Innenstadt*' [2007] ECR I-10451, para. 44.

<sup>712</sup> This is hold true despite that under the TFEU there is no general provisions in the EU law expressly stipulates the elimination of double taxation similar to article 293 of the EC Treaty, see Marjaana Helminen, *EU Tax Law: Direct Taxation*, (IBFD 2011), p.39.

<sup>713</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.670.

<sup>714</sup> The issue of choosing the method for tax avoidance between the CCCTB -Member States will not be relevant under the CCCTB regime as the latter overrides bilateral tax treaties than concluded between such Member States. For discussion on such issue see Klaus Vogel, 'Which Method should the European Community adopt for the Avoidance of Double Taxation', *Bulletin for International Fiscal Documentation*, Vol.56, 2002, pp. 4-10.

it can be said that at the EU level, the CCCTB contributes to the smooth functioning of the Internal Market.

In relation to third countries, the negative effects of international double taxation on the exchange of goods, services and the movement of capital, technology and persons between the Member States of the EU and third countries are commonly eliminated by entering into bilateral double tax treaties between the parties concerned.<sup>715</sup> This could imply that these double tax treaties create a common market between the contracting Member States and third countries similar to the Internal Market that has been created between the Member States themselves. This is mainly because such double tax treaties follow the same objective as the Member States pursue in the Internal Market by the use of the EU law and the CCCTB, i.e. abolishing the obstacles that double taxation presents to the development of economic relations between countries.<sup>716</sup> However, the only difference between the EU's Internal Market and the common market between Member States and third countries with whom the double tax treaties are concluded is the degree of integration. The integration between the Member States' economies is higher than the integration between Member States and the third countries with which the double taxation treaties are concluded, though in both cases the elimination of double taxation is a crucial element for an effective function of the respective economies.<sup>717</sup>

Subsequently, in the same way as the CCCTB promotes the optimal function of the Internal Market by eliminating the negative effects of double taxation,<sup>718</sup> the optimal function of the EU's internal market with third countries' economies requires the prevention of double taxation between the two parties in the context of the CCCTB.<sup>719</sup>

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<sup>715</sup> Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, (Second ed. Kluwer Law International, The Hague, 2002), p.27 et seq.

<sup>716</sup> It should be noted that the relation between the Member States and between the Member States and third countries are somehow different particularly in the context of the free movement of capital, for these differences see ECJ Case C-101/05, '*Shatteverket v A*' 18 December [2007] ECR I-11531, paras . 31-32 and 37.

<sup>717</sup> Eric C.C.M. Kemmeren, CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.670.

<sup>718</sup> For this meaning see Brian J. Arnold, 'Double Taxation in the European Single Market', *Bulletin for International Taxation*, June 2012, pp.295-299, at 299.

<sup>719</sup> Eric C.C.M. Kemmeren, CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.671.

It is submitted that a common market between Member States and third countries is only created by virtue of the conclusion of double tax treaties, and therefore the existence of a double tax treaty with a third country should be the determinant for eliminating double taxation under the CCCTB.<sup>720</sup> It can be argued, however, that in the context of the CCCTB, double taxation with third countries should be abolished regardless of whether the third countries have concluded double tax treaties with Member States or not. This is because the CCCTB common rules in respect of double taxation relief would constitute a multilateral double taxation treaty, which would be binding on the Member States participating in the CCCTB and consequently transposed into their future double tax treaties with third countries.<sup>721</sup> This would mean that, in respect of non-double tax treaty third-countries, any future conclusion of tax treaties between CCCTB-Member States and those countries would be based on the CCCTB rules.

However, this approach raises the risk of a potential conflict between the CCCTB rules and existing double tax treaties with third countries. Nonetheless, the alignment of these tax treaties with the CCCTB rules could be a possible solution in the long run. Finally, distinguishing between third countries with whom a double tax treaty has been concluded and third countries with whom a tax treaty has not been agreed upon in respect to the elimination of double taxation, would undermine the CCCTB's objective of being a common system. Overall, it can be established that the optimal function of Member State' economies with third countries' economies requires the elimination of double taxation with third countries in the context of the CCCTB irrespective of whether these third countries have bilateral tax treaties with Member States or not.

### **4.3 The tax treatment of inbound and outbound payments under the CCCTB**

In general, from a CCCTB perspective, the rules on the taxation of inbound and outbound investment are likely to be different from conventional single country rules in

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<sup>720</sup> Eric C.C.M. Kemmeren, CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.671.

<sup>721</sup> As the treaty tax policy is a part of the national tax policy therefore the CCCTB tax policy in eliminating double taxation will reflected in the Member States ' tax treaties with third countries, see Michael Lang, *Tax Treaty policy*, in Krister Andersson ,Eva Eberhartinger, Lars Oxelheim (Eds.), *National tax Policy in Europe: to be or not to be?* (Springer-Verlag Berlin Heidelberg 2007), p.191.



this respect.<sup>722</sup> The CCCTB taxes the worldwide income of a resident taxpayer, and the income generated from outside the consolidated group is generally included in the CCCTB. Consequently, double taxation would be foreseeable and the corporate tax practice of third countries may be affected in unforeseen ways. To this extent, the CCCTB's tax treatment of income derived from third countries or income flow to entities outside the consolidated group merits examination in order to find out whether the double taxation that occurs in the context of the inflow and outflow income is effectively eliminated or not. In doing so, the possible conflict between CCCTB rules and third countries' existing double tax conventions will be also highlighted.

In accordance with the CCCTB Directive, when reference is made to inbound and outbound payments, this research considers the flow of payments from or into entities that are *outside* of the CCCTB area, *regardless of whether these entities are resident in a Member State or a third country*. In other words, the underlying assumption of the current CCCTB Directive is that outbound and inbound investment mainly refers to investment to and from third countries.

#### **4.3.1 The tax treatment of inbound payments received from third countries**

Under the CCCTB system, according to the worldwide taxation concept, a resident taxpayer is taxed on all income from all sources, either from third countries or from Member States,<sup>723</sup> but double taxation is avoided by providing a combination of both exemption and credit methods. On the one hand, the CCCTB Directive exempts specific types of income received from outside the consolidated group; namely, profit distributions (both portfolio dividends and direct investment), proceeds from a disposal of shares, and income from a permanent establishment located in a third country.<sup>724</sup> It should be stressed that the effect of exempting income of foreign permanent establishment and dividends is for the avoidance of both economic (with regard to taxes on income from dividends) and juridical international double taxation (as regards

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<sup>722</sup> Christoph Spengel and Carsten Wendt, 'A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues und Options' (2007) Oxford University for Business Taxation Working Paper WP 07/17, p.41.

<sup>723</sup> Art. 6(6) of the CCCTB Directive.

<sup>724</sup> Art. 11 of the CCCTB Directive.

business income from a third country's permanent establishment).<sup>725</sup> This is a welcome stance by the CCCTB, knowing that double tax treaties do not cover the elimination of economic international double taxation.<sup>726</sup> However, apart from the foreign permanent establishments' income, the CCCTB Directive does not expressly specify whether the other exempted income is entitled to such tax treatment when it is only received from a third country or from a Member State as well.<sup>727</sup> Seemingly, this income will be tax-exempted regardless of where it is sourced.

In accordance with the CCCTB Directive, exempting a foreign permanent establishment's income, dividends and gains from the disposal of shares means that they will be left *outside the consolidation*. The general rule in the CCCTB Directive is that when calculating the tax base of the recipient taxpayer all *revenues* are taxable unless exemption is invoked.<sup>728</sup> In other words, where such taxpayer is a group member, the exempt income will not be included into its tax base, and consequently will not be added to the consolidated<sup>729</sup> tax base for subsequent apportionment. However, the exemption method provided is the so-called 'exemption with progression'.<sup>730</sup> It implies that a third-country permanent establishment's income, dividends, and the disposal of share proceeds may be taken into account for the limited purposes of determining the average tax rate that would have been applicable to the taxpayer in the residence Member State if such foreign income were taxable.<sup>731</sup> Obviously, this method would be of great relevance to CCCTB-Member States that apply a progressive corporate tax rates approach as well as<sup>732</sup> where different tax rates are applicable to distributed and non-distributed profits, i.e. a split rate approach. Nonetheless, it would be of little relevance where the corporate tax rate is flat. Moreover, in the context of the exemption

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<sup>725</sup> European Commission, 'Possible Elements of a Technical Outline, (26 July 2007, CCCTB/WP057/doc/en), para.123.

<sup>726</sup> Nicoleta Barbuta-Misu, Florin Tudor, 'The International Double Taxation – Causes and Avoidance', *Acta Universitatis Danubius, Economical*, Vol. 5, No. 1, 2009, pp.147-160, at151.

<sup>727</sup> Art. 11 of the CCCTB Directive

<sup>728</sup> Art. 10 of the CCCTB Directive.

<sup>729</sup> Art.57(1) of the CCCTB Directive; the Directive defines consolidation as the result of adding up the tax bases of all group members as calculated under the CCCTB rules see Art.4(11) of the CCCTB Directive.

<sup>730</sup> For other forms of exemption method see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, (Second Edition, Kluwer Law International, The Hague, 2002), pp. 33-34; Dennis Weber & Antonio Russo, 'The 'Switch-over' Clause' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.761.

<sup>731</sup> Art. 72 of the CCCTB Directive.

<sup>732</sup> OECD Model 2010, Commentary on Arts. 23A and 23 B concerning the methods for elimination of double taxation, para.20.

method, the CCCTB Directive uses the expression ‘*revenues*’ while in other provisions the terms ‘*income*’ or ‘*proceeds*’ are invoked. It is submitted that mentioning only ‘*revenue*’ in such provision, which subsequently refers to the positive gross amount, would indicate that the CCCTB should not permit a negative exemption with progression, i.e. the negative items of foreign source income would not be taken into account. In other words, considering that revenue is a gross amount, the expenses related to third country income could not be taken into account. This position is not preferable from a legal policy point of view as it would preclude exempting the foreign income in the event that it is attributed high amount of expenses.<sup>733</sup> Thus, the CCCTB Directive should clarify this point, by stating that the CCCTB-Member States have the right to include foreign source income items, both positive and negative, in the taxpayer tax base for the purpose of determining the applicable tax rate.<sup>734</sup> However, this form of exemption may clash with another form, e.g. the full exemption approach, which is incorporated into the double tax treaties concluded between CCCTB-Member States and third countries. This issue will be subject of Chapter 5.

Apparently, the CCCTB Directive is intended to support the exemption scheme, because it is consistent with the CIN principle.<sup>735</sup> This can point out for a underlying economic policy under which incentives for EU companies to invest in foreign markets are introduced while at the same time the consolidated tax base is protected from contemplated abuses and harmful tax competition by providing anti abuse rules such as a switch over clause and CFC rules as demonstrated below.<sup>736</sup>

On the other hand, income that takes the form of interest, royalties or any other form of payments that are taxed at source and received from outside the group are taxable, and a relief by credit is granted for withholding tax that is paid in the source country.<sup>737</sup> In this regard, the CCCTB Directive does not distinguish between non-CCCTB Member States

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<sup>733</sup> Lang Michal, ‘The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base’ (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.14.

<sup>734</sup> For similar discussion see De Wilde, Maarten Floris, ‘What if all EU MSs Would Subject Non-Resident Taxpayers to Unlimited Income Tax Liability While Providing for DTR under the Dutch-Style ‘Tax Exemption Method’?’, Bulletin for International Taxation, Vol. 65, No. 6, June 2011, p.7, available at <SSRN: <http://ssrn.com/abstract=1862047>> accessed 10 March 2013.

<sup>735</sup> See Chapter 3, section 3.4.

<sup>736</sup> Dennis Weber, Antonio Russo, ‘The ‘Switch-over’ Clause’, in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base*, (Linde 2008), p.756.

<sup>737</sup> Art. 76 of the CCCTB Directive.

and third countries as a source of such passive income. It explicitly states that ‘where a taxpayer derives income which has been taxed in another Member State or in a third country, a deduction from the tax liability of that taxpayer will be permitted’.<sup>738</sup>

In the following sections, the exempted categories of income will be discussed in turn in more detail, starting with the *foreign permanent establishment* income. However, before proceeding to this, the tax treatment of the *EU permanent establishment* should be discussed so as to highlight the difference between the two.

#### **4.3.1.1 Taxation of EU permanent establishments**

In accordance with the worldwide taxation principle, income derived by a resident taxpayer from any sources, whether inside or outside its Member State of residence, is included in the tax base of that taxpayer.<sup>739</sup> This would imply that income from a permanent establishment located in another Member State even if it is a non-CCCTB Member State will be included in the taxable base of the taxpayer. This is because the CCCTB Directive only exempts income of a permanent establishment resident in a *third country*.<sup>740</sup>

The income of the EU permanent establishment is consolidated and apportioned consequently. The CCCTB Directive stipulates that permanent establishments located in the EU have to be treated as members of a group, i.e. their tax bases are to be computed in the same manner as the income of a consolidated group. This means that when the tax bases of the group members are consolidated, the income of the EU permanent establishments is included in that consolidation and consequently the consolidated tax base is apportioned between the group members.<sup>741</sup> As a result of consolidation, profits and losses arising from ‘transactions’ between the head office and its permanent establishment would be ignored in the same way as transactions between other group members are eliminated.<sup>742</sup>

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<sup>738</sup> Art. 76 of the CCCTB Directive.

<sup>739</sup> Art. 6(6) of the CCCTB Directive.

<sup>740</sup> Art. 11(e) of the CCCTB Directive.

<sup>741</sup> Art. 4(7) of the CCCTB Directive.

<sup>742</sup> Art. 59 of the CCCTB Directive.

Normally, a permanent establishment is taxable in the Member State where it is located; therefore, in the case where the permanent establishment is resident in a Member State and its parent company is located in another Member State, the tax base attributable to the permanent establishment will not be included in the tax base allocated to the parent company, rather the tax base apportioned to the permanent establishment would be taxable in the Member State where the permanent establishment is situated.<sup>743</sup> Accordingly, it can be concluded that the income of EU permanent establishments will *always* be consolidated, as long as it falls under the water's edge of a corporate group,<sup>744</sup> either where the head office is located in a non-CCCTB Member State and the permanent establishment is situated in a CCCTB Member State or *vice versa*. Any tax treaty between the two Member States that would otherwise govern the allocation of profits on the basis of transfer pricing or provide for double taxation relief would be, to that extent, inapplicable as the CCCTB rules will take precedence.<sup>745</sup> Thus, the taxation of an EU permanent establishment under the CCCTB rules does not raise *any conflict with double tax treaties* between non-CCCTB Member States and/or CCCTB -Member States.

#### **4.3.1.1.1 EU permanent establishment but owned by third country**

For a permanent establishment located in the EU but owned by a third country, i.e. its head office is resident in a third country, its income that is earned in the EU will also be consolidated and apportioned pursuant to the formulary apportionment as long as it is a member of a corporation group.<sup>746</sup> However, the consolidation of a third-country owned permanent establishment's income would raise a conflict with a third country double taxation treaty due to the *interaction between transfer pricing applicable in that double tax treaty and the formulary apportionment in the CCCTB jurisdiction*.

Overall, the income of the EU permanent establishments, whether owned by a third country or a non-CCCTB Member State, is consolidated and apportioned under the CCCTB rules. The permanent establishment's income is consolidated in the tax base of the consolidated group because the permanent establishment itself is situated within the

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<sup>743</sup> Radhakishan Rawal, *The Taxation of Permanent Establishments: An International Perspective*, (Spiramus 2006), p.16.

<sup>744</sup> Art.55 of the CCCTB Directive.

<sup>745</sup> Art. 8 of the CCCTB Directive.

<sup>746</sup> Art.55 of the CCCTB Directive.

group's water's edge of the CCCTB.<sup>747</sup> If such income were excluded it would be a discriminatory situation pursuant to certain provisions of the double tax treaty concluded especially with third countries; namely, under an Article comparable to Art.24 (3) in the OECD Model Convention.<sup>748</sup> Furthermore, the permanent establishment is commonly affiliated with its parent company, thus it is considered to be an integral part of the group's business in the EU. Therefore, including a permanent establishment's income into the consolidated tax base would reflect the business reality under which an enterprise operating through a permanent establishment is considered to be a unitary business, and consequently the unity of the business is kept, resulting in an accurate apportionment. In contrast, excluding the income would lead to the fragmentation of the business's unity and give incentives for shifting income out of the consolidated tax base.<sup>749</sup> Additionally, if the income is kept outside the consolidated tax base, the tax liability of the permanent establishment would be determined according to the domestic laws and the applicable tax treaties. In other words, the income of the permanent establishment will be calculated under the arm's length principle as it applies in most of the Member States.<sup>750</sup> This contradicts the very goal of the CCCTB of eliminating transfer pricing issues within the EU.

Lastly, consolidating the permanent establishment's income is a departure from the legal fiction concept, under Art.7 of the OECD Model Convention, under which a permanent establishment is considered to be a separate entity in respect to the transaction with its head office and such transaction is subject to the arm's length principle. It is inadequate, however, to apply the arm's length principle to a highly integrated group of companies, especially in highly integrated economies as in the EU.<sup>751</sup> All in all, this is a welcome stance by the CCCTB. However, in relation to the EU permanent establishment owned by a third country, the interaction between the formulary apportionment for allocating the permanent establishment's income and the

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<sup>747</sup> Ekkehart Reimer, Nathalie Urban, Stefan Schmid, *Permanent Establishments: Domestic Taxation, Bil*, (Kluwer Law International 2011), p.11 et seq.

<sup>748</sup> Antonio Russo, 'Formulary Apportionment for Europe: An Analysis and A Proposal', *Intertax*, Vol.33, Issue 1, 2005, p.15.

<sup>749</sup> European Commission, 'The Territorial Scope of the CCCTB', (17/02/2006, CCCTB\WP\026\doc\en),p.9.

<sup>750</sup> European Commission, 'An Overview of the main issues that emerged at the third meeting of the subgroup on International Aspects' (23 November, 2006, CCCTB\WP\049\doc\en\rev),p.14.

<sup>751</sup> Michael Kobetsky, 'Article 7 of the OECD Model: Defining the personality of Permanent Establishments', *Bulletin for International Taxation and Documentation*, 2006, pp.411-425 at 421.

arm's length principle in the OECD-based double tax treaties concluded with third countries (Article equivalent to Art. 7 in the OECD Model) will need to be solved. This issue will be examined in the next chapter.

#### **4.3.1.2 The exemption method for third-countries' permanent establishments**

Exempting foreign permanent establishment income in the CCCTB is in line with the growing practice of most of the Member States in this respect.<sup>752</sup> However, some Member States tax foreign permanent establishments and provide credit for the avoidance of double taxation.<sup>753</sup> These Member States would have to shift to the exemption method, in respect of foreign permanent establishment income, in order to be in line with the CCCTB rules.<sup>754</sup> It should be stressed that the mere existence of the permanent establishment in a third country will not lead to the exemption of all income sourced therein, i.e. only the income that is attributable to the foreign permanent establishment will be subject to exemption.<sup>755</sup> Moreover, since the definition of 'associated enterprise' considers the permanent establishment located in third country as an associated enterprise in relation to its head office in the CCCTB jurisdiction,<sup>756</sup> the arm's length principle applies as regards income attribution to the foreign permanent establishment.<sup>757</sup> This is consistent with Article 7 of the OECD Model.

However, for the purpose of exempting the foreign permanent establishment's income, the CCCTB Directive does not clearly state how such income is computed. This point is raised especially because the CCCTB Directive provides that as a result of applying the switch-over clause in the CCCTB in particular to the income of permanent establishment in third countries, the tax base of that permanent establishment, i.e. its income and expenses, will be calculated according to the CCCTB rules.<sup>758</sup> It can be assumed that the CCCTB rules would not apply in the calculation of foreign permanent

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<sup>752</sup> For example France, Hungary, Belgium and Denmark, see European Commission, 'International Aspects in the CCCTB', (CCCTB\WP\019\doc\en), p.16.

<sup>753</sup> This include, for instance, the UK and Italy ,see surveys included in European Tax handbook, IBFD 2012 and European Commission , International aspects in the CCCTB',(CCCTB\WP\019\doc\en),p.16; Jürgen Lüdicke,' Exemption and Tax Credit in German Tax Treaties – Policy and Reality', Bulletin for International Taxation, December 2010, pp.609-619.

<sup>754</sup> Art.7 of the CCCTB Directive.

<sup>755</sup> Radhakishan Rawal, *The Taxation of Permanent Establishments: An International Perspective*, (Spiramus 2006), p.28.

<sup>756</sup> Art.78 of the CCCTB Directive.

<sup>757</sup> Art.79 of the CCCTB Directive.

<sup>758</sup> Art.74 of the CCCTB Directive.

establishment income. Applying the CCCTB rules in the case of the switch-over clause is for a protective purpose. In addition, the CCCTB rules cannot be applied outside the water's edge of the EU, in order not to contradict the obligations of Member States toward third countries. It seems that the applicable domestic rules or the existing tax treaties would apply.<sup>759</sup> Furthermore, the Directive does not clarify how the losses of third countries' permanent establishments will be treated under the CCCTB system. It is likely that these losses would be tax exempt as well as the profits.<sup>760</sup>

#### **4.3.1.2.1 Rationales for exempting the income of foreign permanent establishments**

Under the CCCTB Directive, the adherence to the exemption method regarding the income of foreign permanent establishments can be justified from a legal tax principle perspective. It is consistent with the principle of *source taxation* as a basis for the allocation of taxing rights between conflicting countries' tax jurisdictions.<sup>761</sup> Furthermore, the exemption of foreign permanent establishment income is in line with the ability to pay concept,<sup>762</sup> and with the direct benefit principle.<sup>763</sup> Additionally, based on some of the ECJ decisions,<sup>764</sup> it is submitted that the exemption of income from a permanent establishment in a third country is compatible with the free movement of capital and the freedom of establishment.<sup>765</sup>

It also satisfies the CIN policy.<sup>766</sup> Unlike the credit method, it is also compatible with the Internal Market's policy<sup>767</sup>, i.e. it would be in line with the water's edge consolidation under the CCCTB. Despite the fact that taxing and consolidating the

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<sup>759</sup> Lang Michal, 'The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base' (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.10.

<sup>760</sup> *Ibid*, p.11.

<sup>761</sup> Vogel, *which method should the European Community Adopt for the avoidance of double taxation*, (IBFD, 2002), pp.4, 10.

<sup>762</sup> Pasquale Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions* (Kluwer Law International 2002), p.202.

<sup>763</sup> Eric C.C.M. Kemmeren, CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.690.

<sup>764</sup> See ECJ C-415/06, *Stahelwerk Ergste Westing* [2007] ECR I-00151; see also ECJ C-298/05, *Columbus Container services* [2007] ECR I-10451, para.57.

<sup>765</sup> Eric C.C.M. Kemmeren, CCCTB and Exemption method for PEs and Major Shareholdings', in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), p.694.

<sup>766</sup> See chapter 3, section 2.4.5.

<sup>767</sup> Ben Terra and Wattel, *European Tax Law* (4<sup>th</sup> ed., 2008, Kluwer Law International), pp.250, 254.



foreign permanent establishment's income according to the worldwide consolidation would satisfy the concept of unitary business, worldwide consolidation (as has been demonstrated in the previous chapter) is practically not reachable at this stage because its drawbacks outweighs its advantages. In contrast, the consolidation of the *EU-permanent establishment income* is workable as it is situated within the consolidated water's edge, and the level of economic integration in the EU would allow such consolidation.

#### **4.3.1.3 The exemption of dividends and gains of disposal of shares**

Unlike the exemption for the income of foreign permanent establishment, the CCCTB Directive does not explicitly state whether both *profit distributions* and disposal of share gains are tax exempt when they are received from third countries or from non-CCCTB Member States.<sup>768</sup> However, it can be inferred from other provisions relevant to the dealings between the group and other entities outside the consolidated group that such income is also exempt regardless of whether it received from third countries or non-CCCTB Member States. For instance, Art. 76 (1) of the CCCTB Directive grants a credit to tax paid abroad on the passive income such as interests and royalties regardless of whether this income is derived from a Member State or a third country. It presumably means that this case is applicable to profit distributions and gains of disposal of shares.<sup>769</sup> Giving the same tax treatment, which is tax exemption, for both profits of permanent establishment and the profit distributions of the companies, and also in both cases capital gains are exempt, promotes tax neutrality in terms of corporate form.<sup>770</sup>

The Directive does not define what constitutes a *profit distribution*. Equally, this term is used in other EU Directives such as the EU-Parent Subsidiary Directive, where it is not also clarified.<sup>771</sup> It is preferable to explain what qualifies as profit distributions; for example, whether it includes portfolio dividends and direct investment, rather than leaving it to the European Court of Justice's interpretation, as in the case of the Parent

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<sup>768</sup> Art.11(c), (d), (e) of the CCCTB Directive.

<sup>769</sup> Art. 76(1) of the CCCTB Directive.

<sup>770</sup> Lang Michal, 'The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base' (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.10.

<sup>771</sup> Art.5 of the Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries.

Subsidiary Directive.<sup>772</sup> Presumably, profit distributions include portfolio dividends and direct investment.<sup>773</sup> This point of view can be based on the definition of the dividends, but the CCCTB Directive does not define dividends.<sup>774</sup> In this respect, the CCCTB Directive could define dividends pursuant to Art.10 (3) of the OECD Model. However, the question would be whether ‘*received profit distributions*’ could be given the same meaning as dividends. Under the CCCTB Directive in connection with the definition of revenues, it has been stated that revenues include, *inter alia*, proceeds for the disposal of assets and rights, interest, dividends and other *profit distributions*.<sup>775</sup> This indicates that *profit distributions* have a wider meaning than *dividends*. Nonetheless, the CCCTB Directive states that ‘income consisting in dividends, the proceeds from the disposal of shares held in a company outside the group and the profits of a foreign permanent establishment should be exempted’.<sup>776</sup> One may assume that the CCCTB Directive intends by this statement to clarify the exempt categories of income which include the received profit distributions, proceeds from disposal of shares.<sup>777</sup> Hence, it can be said that the term ‘income consisting in dividends’ and ‘received profit distributions’ are invoked in a synonymous manner.<sup>778</sup>

Moreover, unlike the exemptions that are incorporated in the national legislation of many countries<sup>779</sup> and under the Parent-Subsidiary Directive, the CCCTB Directive does not specify any minimum shareholding requirements for the exemption of *profit distribution* or the disposal of share gains.<sup>780</sup> In addition, the CCCTB Directive does not describe the legal nature of the participation which creates the entitlement to receive profit distributions. Thus, it is unclear whether corporate tax law is pertinent here or whether a mere obligation is adequate, provided that a corresponding share is held in

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<sup>772</sup> The KPMG Guide to CCCTB ,part II,p.34

<sup>773</sup> European Commission, ‘Anti-Abuse Rules in the CCCTB’, (30 August 2010, CCCTB/RD\004\doc\en),para.15.

<sup>774</sup> Although the CCCTB Directive does not define dividends, but it defines ‘*Interest*’ in line with Art.11 (3) of the OECD Model, which has also been adopted in the Interest and Royalties Directive. See European Commission, ‘Taxable Income’, (CCCTB/WP/017, 07 September 2005), p.5.

<sup>775</sup> Art.4 (8) of the CCCTB Directive.

<sup>776</sup> See Preamble of the CCCTB Directive, para. 11.

<sup>777</sup> Art. 11 of the CCCTB Directive.

<sup>778</sup> Lang Michal, ‘The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base’ (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.14.

<sup>779</sup> European Commission, ‘International Aspects in the CCCTB’, (CCCTB\WP\019\doc\en), p.16.

<sup>780</sup> Lang Michal, ‘The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base’ (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.14.

equity. Likewise, the definite requirements which an entity has to satisfy in order to qualify as a source of distribution of profits are not clarified.<sup>781</sup>

The CCCTB Directive's reliance on the exemption method for dividends and capital gains is justifiable based on two rationales. Firstly, it is a common method currently applied by Member States as a relief for double taxation with regard to dividends and disposal of shares gains.<sup>782</sup> Secondly, it meets the aim of simplicity, because the exemption avoids the need to compute the taxpayer's right to a credit for the tax paid in the source country, especially where such right must take account of the corporate tax paid by the company distributing the dividends, i.e. the amount of credit must exclude the tax payable in third country with regard to the profits out of which the dividends is paid.<sup>783</sup> Additionally, exempting dividends income would relieve economic double taxation as well as juridical double taxation.<sup>784</sup> What is more, it is in line with the source-based taxation system. The exemption of dividends and the proceeds of shares disposal may be substituted by taxation subject to a credit ('switch-over') in certain circumstances as outlined below.

#### **4.3.1.4 The switch-over clause under the CCCTB**

The CCCTB Directive provides for a switch-over to taxation with the credit method in relation to the exempted income in case they are *low-taxed* in third countries.<sup>785</sup> The targeted income is practically *profit distributions*, the disposal of share proceeds and the foreign permanent establishment income.<sup>786</sup> When applying the exemption method to such types of income, the consolidated tax base can be prone to undue avoidance and harmful tax planning.<sup>787</sup> The purpose of the switch-over mechanism is to protect the

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<sup>781</sup> Lang Michal, 'The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base' (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.13.

<sup>782</sup> European Commission, 'Possible Elements of a Technical Outline', (26 July 2007, CCCTB/WP057/doc/en), para.124.

<sup>783</sup> Preamble of the CCCTB Directive, p.11.

<sup>784</sup> European Commission, Possible Elements of the Administrative Framework, (13 November 2007, CCCTB/WP061/doc/en), para.123.

<sup>785</sup> European Commission, 'Transaction and Dealing between the Group and Entities Outside the Group', (1/9/2010, /CCCTB/RD\003\doc/en), p. 4.

<sup>786</sup> Art. 73 of the CCCTB Directive.

<sup>787</sup> For details on tax avoidance and evasion and their consequences see Rachel Anne Tooma (ed.) *Legislating against Tax Avoidance* (IBFD 2008), p.11 et seq.

common tax base from such erosion.<sup>788</sup> In other words, this mechanism acts as a ‘gatekeeper’, which is meant to discourage the inflow of revenues through low-tax countries.<sup>789</sup> This is achieved by making inflows of exempt third-country income subject to tax by triggering the switch-over clause.<sup>790</sup>

The Directive outlines two alternative situations under which the switch-over from exemption to credit will be applicable:

- ‘(a) A tax on profits, under the general regime in that third country, at a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate applicable in the Member States; or
- (b) A special regime in that third country that allows for a substantially lower level of taxation than the general regime’.<sup>791</sup>

A close look at the two possibilities for applying the switch-over clause seems to indicate that the objective of such a mechanism is not only the protection of the tax base where there is low taxation on the profits; it also targets the situations where the exemption scheme is no longer relevant,<sup>792</sup> because double taxation does not arise in the case of a substantial low level taxation in the source state, and thus continuing to exempt the same income would result in double non-taxation.<sup>793</sup> Therefore, the credit method can be more effective than exemption in achieving the objective of avoiding double non-taxation.<sup>794</sup>

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<sup>788</sup> European Commission, CCCTB: Possible Elements of the Administrative Framework, (13 November 2007, CCCTB/WP061\doc\en), para.79, and 127.

<sup>789</sup> European Commission, ‘Anti-Abuse rules in the CCCTB’, (30 August 2010, CCCTB/RD\004\doc\en),para.15.

<sup>789</sup> The KPMG Guide to CCCTB ,part II,p.34

<sup>790</sup> For more discussion of switch-over clause that targets certain types of income see Burgstaller, Schilcher, ‘Subject-to-Tax clauses in Tax Treaties’, *European Taxation*, Vol.44, 2004, pp.266, 267; Gupta, ‘Subject-to-Tax Clauses in Tax Treaties’ in Markus Stefaner ,Mario Zuger, *Tax Treaty Policy and Development*(Linde 2005),pp.177,180.

<sup>791</sup> Art. 73(a), (b) of the CCCTB Directive; European Commission , Possible Elements of the Administrative Framework, Brussels, 13 November 2007, Taxud TF1, CCCTB/WP061\doc\en, Para.128; European Commission, ‘Anti-Abuse rules in the CCCTB’, (30 August 2010, CCCTB/RD\004\doc\en),para.16.

<sup>792</sup> Some European Member States such as German applies the switch-over clause in such case , see Resch, R., ‘The New German Unilateral Switch-Over and Subject-to-Tax Rule’, *European Taxation* ,Vol. 47,No.10,2007,pp. 480-483.

<sup>793</sup> Rolf Eicke, *Tax Planning with Holding Companies - Repatriation of Us Profits from Europe*(Wolters Kluwer 2009),p.21.

<sup>794</sup> Dennis Weber and Antonio Russo, The ‘Switch-over’ Clause’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds), *Common Consolidated Corporate Tax Base* (Linde 2008) , p.758

More specifically, by reading these two conditions in conjunction, it can be seen that in essence the first condition mainly constitutes a protective measure for the consolidated tax base, while the second case is for the elimination of double non-taxation. Moreover, it can be seen from the two conditions above that essentially the switch-over clause' is applicable only towards third countries, whereas the exemption method applies irrespective of the country from which the relevant income is sourced.<sup>795</sup>

#### **4.3.1.4.1 Low- taxed profits in third countries**

Low-taxation in the source state is considered to be a major criterion or factor for the implementation of the switch-over clause. The average statutory corporate tax rate applicable in the Member States is provided so as to measure low-tax regimes in third countries. Since it is apparently the statutory tax rate in the third country that is relevant, and not the effective tax rate, objective tax exemptions or tax holidays under a third-country's general tax regime or state subsidies will not constitute low taxation. Similarly, since the nominal tax rate is the sole determinant, i.e. the switch-over clause is applicable in any case if the nominal rate is lower than the specified threshold, the switch-over clause applies even if the tax liability in third countries is high by virtue of a broad tax base and even if it is higher than in the controlling shareholder's Member States.<sup>796</sup> Nonetheless, this approach is easy to apply, as *the average statutory corporate tax rate applicable in the Member States shall be published by the Commission annually.*<sup>797</sup> In this regard, it has been suggested that the average statutory corporate tax rate applicable in the Member States can be linked up with the study of 'Taxation trends in the European Union' which is published annually by the European Commission and Eurostat. In this study in 2007, the average corporate tax rate in the EU was 24.5%. 40% of this average is 9.8%, which means that if the tax rate applicable in a third country is less than the latter percentage, the switch-over clause would be triggered.<sup>798</sup> Any adjustment that occurs in the average tax rate will be applied to the taxpayers in

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<sup>795</sup> The KPMG Guide to CCCTB ,part II,p.34

<sup>796</sup> Lang Michal, 'The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base' (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.19.

<sup>797</sup> Art. 73 of the CCCTB Directive.

<sup>798</sup> Dennis Weber and Antonio Russo, 'The 'Switch-over' Clause' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* , (Linde 2008) , p.758

their tax year following the adjustment.<sup>799</sup> This makes the approach workable in practice.

However, this approach could be problematic when calculating the 40% of the average statutory corporate tax rate applicable in the Member States; it should be taken into account that some Member States have a progressive corporate tax rate while some others recognize the general exemption which is the same as a corporate tax rate of 0%. Therefore, the CCCTB Directive states that the average will be computed as an arithmetical average.<sup>800</sup> This means that these differences will be taken into consideration.

#### **4.3.1.4.2 Special tax regime in third countries**

The switch-over clause is also applicable where a third country provides for a special regime, which results in a substantially lower level of taxation than the general tax regime of that country. Firstly, the CCCTB Directive does not specify which general regime is required, i.e. that of the Member State or of the third country concerned. However, it is presumably the latter. When the tax system derogates from the general regime it will be regarded as a special regime, but how this special regime can be recognised when it derogates from the general system is unclear as the CCCTB Directive does not explain what constitutes a special regime. It has been suggested that the selectivity of tax rules<sup>801</sup> should be the benchmark for recognising a special regime, i.e. when the tax system provides for selective rules that are different from the general regime. The selectivity would be regarded with both the tax rate and tax base rule as well.<sup>802</sup> However, in such a case, the CCCTB regime would have to be the standard, meaning that exempting permanent establishment income, profit distributions and capital gains in third countries would not constitute a special regime. The *selectivity* criterion is ambiguous.<sup>803</sup> Therefore, some clarification is needed on this expression.

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<sup>799</sup> See Art.73 of the CCCTB Directive.

<sup>800</sup> See Art.73 of the CCCTB Directive.

<sup>801</sup> This criterion is inspired from the interpretation of Art.87 on what constitutes as a state aid , a national measure can be considered an aid measure if this is a selective measure, see Opinion of General Advocate Darmon delivered on 17 March 1992 on ECJ C-72/91[1993] ECR I I-00887, para. 47.

<sup>802</sup> *Ibid.*

<sup>803</sup> Michael Lang, Hans-Jorgen, Ulrich Scheuerle and Markus Stefaner, *CFC legislations, Tax treaties and EC law* (Kluwer law international 2004), pp.19, 20.

Identifying the ‘special regime’ can be done through a ‘*case-by-case*’ approach or alternatively a list including what constitutes a special regime could be published by the European Commission. The latter approach is recommended as it would aid certainty and clarity, because the taxpayer would be able to predict when the switch-over clause is applicable, and the different interpretations by different Member States would be avoided. Moreover this could put political pressure on the third countries to amend their tax regimes.<sup>804</sup> Furthermore, as the CCCTB Directive requires that the special regime has to result in a ‘*substantially lower level of taxation*’, the meaning of this phrase needs to be specified, i.e. identifiable standards for measuring ‘*substantially*’ are needed.<sup>805</sup>

The switch-over clause applies to all third countries. Unlike the CCCTB’s CFC rules, there is no exception under these rules for low-taxed income derived from European Economic Area (EEA) states, whether or not there is an applicable information exchange mechanism. Accordingly, the switch-over clause may conflict with existing tax treaties concluded with third countries where the relevant tax treaty does not contain such a clause.

Finally, although the above mechanism is referred to in the CCCTB Directive as a ‘switch-over clause’, it is merely a switch from exemption to taxation in respect to the foreign permanent establishment income, profit distributions and capital gains. In other words, the relevant provision (Art.73 of the CCCTB Directive) does not clearly stipulate a switch-over to the credit method.<sup>806</sup>

#### **4.3.1.5 Calculation of the foreign permanent establishment income**

As a result of applying the switch-over clause in the CCCTB, the income of foreign permanent establishment will be taxable under the CCCTB. Hence, the tax base of that permanent establishment, i.e. its income and expenses and other deductible items, will

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<sup>804</sup> Dennis Weber and Antonio Russo, ‘The ‘Switch-over’ Clause’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base*, (Linde 2008), p.759.

<sup>805</sup> For the other approaches on defining the special tax regime see Michael Lang, Hans-Jorgen, Ulrich Scheuerle and Markus Stefaner, *CFC legislations, Tax treaties and EC law* (Kluwer law international 2004), pp.19, 20.

<sup>806</sup> Lang Michal, ‘The Principle of Territoriality and its Implication in the Proposal for a Council Directive on a Common Consolidated Tax Base’ (2012) Research Paper WU International Taxation Research Paper Series No.2012-09, p.22.

be calculated according to the CCCTB rules.<sup>807</sup> This implies that the foreign permanent establishment income is determined pursuant to the transfer pricing rules of the CCCTB and a relief by credit is to be granted for the elimination of double taxation. In addition, it is said that stipulating the calculation of permanent establishment income in such a way especially after applying the switch-over clause has the purpose of clarification, as according to the other provisions of the CCCTB Directive the tax base already includes revenues (if not exempted) realised abroad.<sup>808</sup> However, this does not mean that its income would be consolidated, as it is outside the water's edge of consolidation.

#### **4.3.1.6 Credit Method for double tax relief regarding interest and royalties and other income taxed at source and CCCTB rules for credit sharing**

In principle, according to the CCCTB Directive, income other than exempted income derived by a taxpayer, either from a third country or from an EU-Member State, is included in the tax base of that taxpayer and accordingly taxed with relief by credit for the withholding tax paid abroad. More specifically, withholding tax imposed on interest, royalties and other income taxed in third country is credited.<sup>809</sup> Since the CCCTB Directive states that '*any other income taxed at source is entitled to a credit*',<sup>810</sup> it seems that the relief by credit also covers the income which is taxable by virtue of the switch-over clause, i.e. foreign permanent establishment income, dividends and the disposal of share proceeds. This would be the case where, for instance, such income is received from a third country because the switch-over clause is not applicable within the CCCTB jurisdiction. However, it is argued that underlying withholding tax imposed in a third country on the (originally exempt) *dividends* but taxable due to the application of the switch-over clause would not be subject to the credit method. This argument is based on the viewpoint that it is not the dividend income derived by the taxpayer from the third country that has been subject to corporate tax in that third country,<sup>811</sup> but rather the underlying profits out of which the dividends are paid that have been subject to such tax.<sup>812</sup> It would seem that the credit method should apply to dividends taxable under the switch-over clause, as such income is distributed after levying the corporate tax in the

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<sup>807</sup> Art. 74 of the CCCTB Directive.

<sup>808</sup> Arts. 10 and 4 of the CCCTB Directive.

<sup>809</sup> Art. 76 (1) of the CCCTB Directive

<sup>810</sup> *Ibid.*

<sup>811</sup> This solution is suggested under the assumption that those dividends are distributed after imposing the corporate tax on the profits of a company.

<sup>812</sup> The KPMG Guide to CCCTB, part II, p.54.



third country in order to eliminate double taxation. However, the credit amount should not include the corporate tax payable in the third country in respect to the profits out of which the dividends are paid.<sup>813</sup> Furthermore, the CCCTB Directive refers to ‘*any other income that is taxed at source*’, i.e. it does not distinguish between dividends and other income.

The credit method adopted by the CCCTB Directive is the *ordinary credit method* rather than the full one.<sup>814</sup> This means that the credit granted is limited to an amount equal to the one resulting from applying the corporate tax rate of the Member State residence of a *taxpayer* or of a permanent establishment’s country of residence to the income attributable to such taxpayer or permanent establishment.<sup>815</sup> The scheme of the ordinary credit method is preferred over the unilateral rule for full credit, in particular when taxes are levied in third countries, because it is operated by most domestic tax systems, on the ground that it is the best practice in international tax law.<sup>816</sup> It is believed that the ordinary credit method promotes CIN policy.<sup>817</sup>

Moreover, the CCCTB Directive does not provide for foreign tax credit carry-forward in the case of unused tax credit (the foreign tax that is not deducted against the tax payable in the residence Member State of the taxpayer) or where the taxpayer who received the foreign income realises an overall loss in the year in which it receives such income and is not subject to tax in the residence Member State, i.e. there are no taxes against which the withholding taxes could be credited. The latter would not occur in practice, as the loss of one group member will be offset against the profits of other group members, unless the whole consolidated group realises an overall loss. In this

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<sup>813</sup> Jacques Malherbe & Daniel Garabedian, ‘Credit Method for Portfolio Dividends, Interest and royalties’, in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.709.

<sup>814</sup> For the principle of credit method see OECD (2010) the commentary on Arts 23B.

<sup>815</sup> Art.76(3) of the Council Directive

<sup>816</sup> The justification for this choice reads as follows:

‘A situation in which EU Member States would grant full credits to domestic companies in regard to withholding taxes levied in third countries while the same benefits would not be available for companies resident in third countries in regard to withholding taxes levied in the EU would result in reduced tax revenues for Member States, weaken their negotiation position when amending DTCs and minimise then incentives for third countries to abolish or reduce withholding taxes on payments to companies resident in the EU’,

see European Commission, CCCTB/RD/003, para. 12 and footnote 2 in p.5.

<sup>817</sup> Matthew Haag, Andrew B. Lyon, ‘Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations’ (January 2004), p.16, Available at <SSRN: <http://ssrn.com/abstract=497382> > or <<http://dx.doi.org/10.2139/ssrn.497382>> accessed 10 March 2013.

case the CCCTB Directive should provide for credit carry-forward as the income received from third countries will be indirectly taxed twice, i.e. firstly in third countries in the year of distribution and secondly in the year in which the consolidated group becomes profitable, as in calculating the profits only a reduced loss carry-forward is taken into account.<sup>818</sup> It seems that the unused credit would not be subject to carry-forward for future years.<sup>819</sup> However, it would be subject to the applicable tax treaties between the third country and the Member State concerned, or to the national legislation if this provides so.

Where the taxpayer receiving the income which has been subject to credit method is a member of a CCCTB group, such income will be included into the consolidated tax base and shared between the group members pursuant to the formulary apportionment.<sup>820</sup> However, the CCCTB Directive does not clarify this issue. It does not provide detailed rules on the consolidation of the foreign income, i.e. whether it is included in the tax base of the recipient taxpayer and then consolidated, or added to the consolidated tax base. It seems that the foreign income should not be included in the recipient's tax accounts<sup>821</sup> but should rather be added to the consolidated tax base of the group and then shared out. It would be very complex if the payments from a third country are included in the account of an individual group member and then consolidated as it would not be possible to say which group member or members such income is attributed to.<sup>822</sup>

Since the consolidated tax base, including the foreign income, is shared among more than one Member State, it would not be fair if just one such State granted the credit for the entire amount of withholding tax imposed in the third country. Therefore, the credit

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<sup>818</sup> Veronika Daurer, Nicole Tuchler, 'Foreign Tax Credit – Is a Carry-Forward Obligatory?' Bulletin for International Taxation, October 2012, pp.563-571, at 564.

<sup>819</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.12.

<sup>820</sup> *Ibid*, para.11.

<sup>821</sup> In this context, consolidation means that after calculation of each group member tax base as revenues less exempted revenue, deductible and non-deductible expenses, the tax bases of all group members will be added up together resulting in the consolidated tax base. See Art.4 (7) and Art. 11 of the CCCTB Directive.

<sup>822</sup> Philip Baker & Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008),p.642.

for the tax paid abroad will be shared among the group members<sup>823</sup> according to the same formula apportionment which is provided for the allocation of the consolidated tax base within the consolidated group.<sup>824</sup>

However, it has been argued that the formula apportionment as a mechanism for revenue allocation is not relevant for the apportionment of tax credits. The formulary apportionment comprises three equally weighted factors (labour, sales and assets), and the allocation of income is based on the presence of these factors in the accounts of each group member. Thus, such a mechanism is designed for the allocation of the consolidated tax base but not taxes.<sup>825</sup> It can be said that as the foreign income which has borne the tax abroad is apportioned on the basis of formulary apportionment, allocating the tax credit on the same formula implies an indirect link between the formula apportionment and the tax credit.

Since the credit method applies to the tax liability, the sharing of the credit will be calculated after the determination of the tax liability of each group member and it will not be included in the consolidated tax base.<sup>826</sup> In other words, the allocated amount of the credit to each Member State is deducted from its tax liability, i.e. after applying the tax rate of each member to the apportioned share of the consolidated tax base.<sup>827</sup> The amount of credit deducted will not necessarily be the same, because the tax rate of each Member State is mirrored in the amount of credit granted, particularly under the ordinary credit method.<sup>828</sup>

In calculating the maximum allowable tax credit, the income received from third countries will be reduced by relevant deductible expenses. The foreign tax imposed on interest, royalties and other types of income is levied on the gross amount, while the same income is taxed on the basis of the net amount in the Member State residence of the recipient. Thus, certain adjustments to such income as regards the related expenses

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<sup>823</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.11.

<sup>824</sup> Art. 76(2) of the CCCTB Directive.

<sup>825</sup> Philip Baker & Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.641.

<sup>826</sup> European Commission, Impact Assessment, SEC (2011) 315 final, p.97.

<sup>827</sup> Art.103 of the CCCTB Directive.

<sup>828</sup> European Commission, The Territorial Scope of the CCCTB, (CCCTB\WP\026\doc\en), p.5.

would be required in order to obtain an accurate amount of the total credit,<sup>829</sup> otherwise discrepancies would arise. In order to tackle this inaccuracy, no idealistic solution is suggested by the CCCTB Directive: it is assumed that the related expenses represent a fixed percentage of the income concerned, counting as a 2% decrease of the inflow income. However, this amount is subject to an escape clause, as the taxpayer is permitted to prove that the relevant deductible expenses exceed this figure.<sup>830</sup>

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<sup>829</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.14.

<sup>830</sup> Art. 76(4) of the CCCTB Directive; European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.14.

#### 4.3.1.6.1 Example

This example explains how income derived by a taxpayer from a third country is apportioned among the group members; it also illustrates how the withholding tax paid abroad is apportioned.<sup>831</sup>

Assume that the CCCTB group comprises three companies resident in different Member States (MS1, MS2 and MS3), and each Member State shares one third of the consolidated tax base pursuant to formulary apportionment.

Corporate tax rates:

MS1 20%

MS2 15%

MS3 30%

CCCTB: <i>Income sourced in the Member States</i>	300
Deductible expenses	(330)
<i>Foreign income</i> (added into the consolidated tax base)	
Interest (gross) with the source in a third country	100
Withholding tax on the interests in a third state (not included in the consolidation)	[20]
Royalty (gross) with the source in a third country	50
Withholding tax on the royalty in a third state (without inclusion in the consolidation)	[5]
<b><i>Consolidated base</i></b>	<b>120</b>

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<sup>831</sup> This example is modified according to the final CCCTB Directive proposal, for the original example see European Commission, 'Possible Elements of a Technical Outline, (CCCTB/WP057/doc/en), para.137.

		MS1	MS2	MS3
Share of CCCTB <sup>(1/3* 120)</sup>		40	40	40
* rate		*0.20	*0.15	*0.30
Tax liability in an MS before credit		8	6	12
Income with the source in a third state calculation (one third of [gross income - related expenses])	Interest	$1/3*(100 - (0.02*100)) = 32.67$	$1/3*(100 - (0.02*100)) = 32.67$	$1/3*(100 - (0.02*100)) = 32.67$
	Royalty	$1/3*(50 - (0.02*50)) = 16.33$	$1/3*(50 - (0.02*50)) = 16.33$	$1/3*(50 - (0.02*50)) = 16.33$
Maximum credit capacity for interest : <i>Lower of</i>	Tax paid abroad (20)	$20/3 = 6.67$	$20/3 = 6.67$	$20/3 = \mathbf{6.67}$
	Notional tax in an MS	$0.2*32.67 = \mathbf{6.53}$	$0.15*32.67 = \mathbf{4.9}$	$0.3*32.67 = 9.8$
Maximum credit capacity for royalty: <i>Lower of</i>	Tax paid abroad (5)	$5/3 = \mathbf{1.67}$	$5/3 = \mathbf{1.67}$	$5/3 = \mathbf{1.67}$
	Notional tax in an MS	$0.2*16.33 = 3.27$	$0.15*16.33 = 2.45$	$0.3*16.33 = 4.9$
Total credit		$6.67+1.67 = 8.34$	$6.67+1.67 = 8.34$	$6.67+1.67 = 8.34$
Total allowable deduction for tax paid abroad		$6.53+1.67$ but not more than 8	$4.9+1.67$ but not more than 6	$6.67 + 1.67 = 8.34$
Corporate Tax due after deduction of foreign tax		0	0	3.66
Excessive credit (deduction allowed only if the <i>full</i> credit method is stipulated by the tax treaty)		0.34	2.34	0

**Table 1: Calculation and apportionment of foreign tax credit under the CCCTB system**

The above calculation of tax credit is carried out under the assumption that the foreign income is derived from one third country. However, when the foreign income is sourced from more than one third country, the calculation of the credit would not be on a pooling basis, it would be computed individually with respect to each Member State or third country and for each type of income separately.<sup>832</sup> Although this method of foreign credit calculation is prevalent in most Member States' tax systems, and reflected in their double tax treaties with third countries,<sup>833</sup> in the context of the CCCTB it would become administratively burdensome, and it is submitted that it would lead to an insufficient allocation of capital.<sup>834</sup>

Ultimately, there is a limitation in the CCCTB Directive which states that where the third country tax exceeds the final tax liability of *a taxpayer*, the excess is not credited unless a tax treaty concluded between the residence Member State of the taxpayer and the third country states otherwise.<sup>835</sup> The CCCTB Directive does not lay down whether this is the final tax liability in respect of the relevant income or the overall final tax liability of the taxpayer.<sup>836</sup> It appears from the example above that the CCCTB Directive intends the overall final tax liability of the taxpayer, which means that the full credit method would apply in cases where it is provided by such double tax treaty as an exception to the general rule of the ordinary credit method.<sup>837</sup>

Overall, when tax treaties concluded between potential CCCTB-Member States and third countries provide for an exemption method in respect to the above-mentioned income, or a credit method but with more generous relief, this may contradict the CCCTB Directive. This issue will be examined in the next chapter.

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<sup>832</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.13; Article 76(3) of the CCCTB Directive

<sup>833</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.13.

<sup>834</sup> Matthew Haag, Andrew B. Lyon, 'Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations' (January 2004), p.16, Available at <SSRN: <http://ssrn.com/abstract=497382> > or <<http://dx.doi.org/10.2139/ssrn.497382>> accessed 10 March 2013.

<sup>835</sup> Art. 76(5) of the CCCTB Directive

<sup>836</sup> The KPMG Guide to CCCTB, part II, p.53.

<sup>837</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.12.

### 4.3.2 The tax treatment of outbound payments to third countries

It would seem that the tax treatment of outbound payments would be more perplexing than the inbound income tax treatment, since it is less settled in the CCCTB Directive, and it can be noticed that fewer details and distinctions are provided where the outbound income is concerned.<sup>838</sup> In other words, unlike the tax treatment of the inbound payments, the CCCTB Directive does not provide common rules for the tax treatment of outbound payments.

Principally, outbound payments are taxable in the Directive, which elucidates that *'interest and royalties paid by a taxpayer to a non-taxpayer outside the group may be subject to withholding tax in the Member State of source according to national rules and subject to applicable tax treaties'*.<sup>839</sup> This means that the withholding tax rate within the consolidated group will be that of the applicable tax convention with the third country to which the payments flow. Withholding taxes are levied on payments flowing to a recipient outside the consolidated group regardless of whether it is in a third country or in a Member State, and whether or not the recipient is a single company applying the CCCTB system or another separate consolidated group.<sup>840</sup> Thus, the Directive's concern is that the outgoing payments are made by a taxpayer<sup>841</sup> to a non-taxpayer outside the consolidated group either because it has not opted for the CCCTB system or does not qualify for consolidation.<sup>842</sup>

As a result of the adherence to the national tax rules and the current tax treaties regarding the tax treatment of the withholding tax on outgoing payments, i.e. no common rules are provided, the European Commission has advocated Member States to work *'towards common arrangements in order to prevent distortions in patterns of investment'*.<sup>843</sup> Coordination between the CCCTB Member States in respect of such

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<sup>838</sup> The CCCTB Directive provides for only one article for the treatment of the outbound payments; see Art. 77 of the CCCTB Directive.

<sup>839</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB\RD\003\doc\en), para.15.

<sup>840</sup> European Commission, 'CCCTB: 'Possible Elements of Technical Outline' (CCCTB57), para. 18.

<sup>841</sup> A 'taxpayer' is used in the discussion document to refer to companies that have opted for the CCCTB: see Art.4 (1) CCCTB Directive; European Commission, 'CCCTB: 'Possible Elements of Technical Outline' (CCCTB57), para. 13.

<sup>842</sup> See Art. 77 of the CCCTB Directive.

<sup>843</sup> European Commission, 'CCCTB: 'Possible Elements of Technical Outline' (CCCTB57), para. 18.



payments will therefore be required as a remedy for the absence of the common rules in the CCCTB Directive, at least in the short term.

As mentioned, withholding taxes and other source taxation on outward payments would continue to be ruled by the existing arrangements.<sup>844</sup> However, where the *taxpayer* who imposes the withholding tax is a group member, the tax will be shared among the Member States of the other members of the group according to the applicable formula in the tax year for which the tax is charged.<sup>845</sup> The current Directive distinguishes between withholding taxes on outbound interest and royalty payments and withholding taxes on dividend distributions.<sup>846</sup> For interest and royalty payments, proceeds from applying withholding taxes are shared out between the Member States of the group members pursuant to the formula apportionment in the CCCTB.<sup>847</sup> By contrast, there is no sharing out of withholding taxes on dividends between group members. These will continue to be dealt with at national level.<sup>848</sup> Therefore the treatment of dividends will be entirely subject to the relevant national rules and existing tax treaties.

The treatment of withholding tax on dividend distributions, i.e. apportionment of the income, is justifiable as they are after-tax payments, meaning that after the tax base is consolidated and then apportioned to the Member States concerned, the dividend distribution is carried out after the determination of the tax liability of each group member; it is not consolidated and consequently not apportioned.<sup>849</sup> Hence, the distribution of dividends does not influence the consolidated tax base or the taxable base

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<sup>844</sup> European Commission, 'CCCTB: 'Possible Elements of Technical Outline' (CCCTB57), para. 18.

<sup>845</sup> Art. 77 of the CCCTB Directive

<sup>846</sup> For the previous suggestion on the treatment of these outbound payments see European Commission, an overview of the main issues that emerged at the third meeting of the subgroup on international aspects (SG 4), Brussels, 23 November, 2006, CCCTB\WP\049\doc\en\rev, para.9; CCCTB57, fn.20, paragraph 18; CCCTB/RD\003, fn.9, Para. 15.

<sup>847</sup> European Commission, 'Transaction and Dealing between the Group and entities outside the Group, (CCCTB/RD\003\doc\en), para.15; Art. 77 of the CCCTB Directive.

<sup>848</sup> Although this is expressly stated by the European Commission, this point is not made in Art. 77 of the CCCTB Directive, which merely deals with the treatment of withholding taxes on outbound interest and royalty payments. However, the distinction is made clear and the reasons behind it explained in paragraph 18 of the preamble ,see Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.69.

<sup>849</sup> *Ibid*, p.70.

of any other group member.<sup>850</sup> Therefore, there should be no division of withholding tax proceeds.

It follows that the tax treatment of dividend distributions simply follows the applicable domestic rules and double tax conventions. In particular, if these payments are made to a third country the applicable rate in the double tax convention will apply and the proceeds of the imposed withholding tax do not need to be shared out between the consolidated group members. In contrast, royalties and interest are deductible from the payer's tax accounts, which are consolidated and apportioned across the group members, thus the overall tax base is reduced.<sup>851</sup> Moreover, since the amounts of outbound payments (interest and royalties) are deducted from the consolidated tax base of the group, sharing the withholding tax collected by one group member within the other group members is justified. In other words, the withholding tax will be added to the consolidated tax base and then apportioned across the Member States of the group members pursuant to the CCCTB-formulary apportionment.<sup>852</sup>

However, it is submitted that the formulary apportionment is not appropriate for the apportionment of the withholding tax proceeds across the consolidated group. It has been argued that the apportionment of the withholding tax imposed on royalties and interest should not be based on the same principle as that for the allocation of the consolidated tax base, i.e. formulary apportionment factors. As the proper allocation of the proceeds of the withholding tax should be linked to the payments on which the withholding tax is levied, formulary apportionment is not relevant for the apportionment of the withholding tax.<sup>853</sup> Accordingly, it is suggested that another way of dealing with the problem is to refrain from deducting the royalties and interest from the consolidated tax base and accordingly to leave the withholding taxes that are levied on the respective

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<sup>850</sup> Philip Baker/ Ioanna Mitroyanni, 'CCCTB rules and Tax Treaties', in Michael Lang, Pasquale Pistone, Josef Schuch, Claus Stringer (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), p.641

<sup>851</sup> European Commission, 'Transaction and dealing between the Group and entities outside the Group', (CCCTB/RD/003/doc/en), para.15; para; the preamble of the CCCTB Directive, para.19.

<sup>852</sup> Art. 77 of the CCCTB Directive; the CCCTB Directive provides for the Formula Apportionment in the Arts. 86 to 102; European Commission, 'An Overview of the Main issues that emerged at the Third meeting of the subgroup on International Aspects' (23 November, 2006, CCCTB/WP/049/doc/en/rev), p.3.

<sup>853</sup> Philip Baker & Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008),p.649.

payments outside the apportionment. Interest and royalties would be deducted from the taxable share allocated to the Member State of the payer, and the withholding tax would be imposed at the tax rate applicable in the relevant double tax treaty with the third country, and to be kept by the Member State that levies it.<sup>854</sup>

However, as said earlier, using the formula apportionment for allocating the deducted payment of interest and royalties between the group members makes the formula relevant for the apportionment of the withholding tax that is imposed on such payments. Moreover, the suggested solution would increase complexity as the Member State of residence of the payer would have to keep two different accounts: one in relation to third countries and another one concerning the other group members.

As said, the CCCTB Directive does not provide for common rules in respect to taxpayer payments to a company resident in a third country, but it refers to existing national and tax treaty arrangements. The respective provisions of current tax treaty arrangements with third countries permit the imposing of withholding taxes, but these treaties allow for limited withholding taxes as most of them follow the OECD Model.<sup>855</sup> In contrast, the imposition of withholding taxes according to source-based taxation in the CCCTB would allow for unlimited taxation on these types of passive income, which is why the Directive referred to the existing tax treaties. This stance taken by the Directive can be justified by the need to avoid the distortion of the investments, because providing common provisions on the outbound payments (inbound investment) would give rise to conflict with the current tax treaty arrangements.

Moreover, the current tax treaties can offer protection against discrimination in respect to the treatment of outgoing dividends and passive income paid to a third country. This protection will be significant if the tax treaty in place contains a provision on the exchange of information.<sup>856</sup> In other words, non-discrimination will not arise in relation

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<sup>854</sup> Philip Baker & Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.649.

<sup>855</sup> Carsten Wendt, *A common consolidated corporate tax base in the European Union* (Gabler 2008), p.187.

<sup>856</sup> Case C-101/05 *Shatteverket v A* [2007] ECR I-11531, paras.42, 43, 55, 63, 67; Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue* [2008] ECR I-02875.

to third countries in respect of the treatment of passive income as long as there is an exchange of information mechanism in the relevant tax treaty.

#### **4.4 Anti-abuse provisions in the CCCTB Directive: Is the common tax base sufficiently protected?**

In general, anti-abuse rules are established in the domestic legislations of the Member States for purpose of tax base protection against tax avoidance and non-taxation.<sup>857</sup> Tax abuse and non-taxation frequently result from the lack of cooperative interaction between the tax systems of the Member States concerned.<sup>858</sup> The anti-abuse rules are only relevant to cross-border relations, i.e. they are not applicable in purely national situations.<sup>859</sup> The concept of anti-abuse rules includes wide-ranging of rules such as the General Anti-Abuse Rule (GAAR), either based on legislation or developed in case law,<sup>860</sup> which is applied by some Member States.<sup>861</sup> Other Member States adopt specific anti-abuse rules such as Controlled Foreign Corporation (CFC), Thin Capitalisation rules, and the switch-over from exemption of foreign income to relief by credit. Several Member States apply general anti-abuse rules in conjunction with specific anti-abuse provisions.<sup>862</sup>

Under the CCCTB Directive, anti-abuse rules are required mainly because the territorial scope of the consolidated tax base is limited to the water's edge of the EU (see previous chapter). Moreover, taxing the foreign income and using the exemption method for the elimination of double taxation means that the deduction of interest paid to third countries from the consolidated tax base, and the exemption of capital gains, would necessitate enabling anti-abuse measures in order to protect the common tax base from thin capitalization and from shifting income outside the water's edge through CFCs. The CCCTB Directive established certain common provisions on GAAR which target

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<sup>857</sup> For definition of tax avoidance and tax evasion see Zoë Prebble and John Prebble, 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law', *Bulletin for International Taxation*, April 2008, pp. 151-170, at 152.

<sup>858</sup> European Commission, 'The Application of Anti-abuse Measures in the Area of Direct Taxation – within the EU and in relation to Third Countries' (Communication) COM(2007) 785 final, p.6.

<sup>859</sup> Marjaana Helminen, 'EU Tax law Direct Taxation', (IBFD 2011), p.126.

<sup>860</sup> For the History of GAAR see William I. Innes, Patrick J. Boyle, Joel A. Nitikman, *The Essential GAAR Manual: Policies, Principles and Procedures* (CCH Canadian Limited 2006), p.7 et seq.

<sup>861</sup> For example Greece, Malta and Slovakia, see Karen B. Brown (ed.), *A comparative Look at Regulation of Corporate Tax Avoidance*, (Springer 2012), p.20 et seq.

<sup>862</sup> For more details about anti-abuse rules in different Member States in the EU see surveys included in the European Tax handbook, IBFD 2012.

the ‘*wholly artificial transactions*’ and apply within the EU and to third countries. Moreover, the CCCTB Directive adopts common targeted anti-abuse rules. This includes the disallowance of interest deduction, CFC rules, and the switch-over clause, as outlined above. However, the specific anti-abuse rules are only applicable to third countries.

Against this background, the frameworks of the GAAR and specific anti-abuse rules in the context of the CCCTB have to be outlined to find out whether the common tax base is sufficiently protected. In doing so, the scope of the anti-abuse rules will be identified. There are three possibilities for applying the anti-abuse rules in the CCCTB: between the Member States participating in the CCCTB, between the CCCTB Member States and other countries in the EU, or between the CCCTB Member States and third countries. Important parameters in determining the scope are the EU law and the ECJ’s case law, i.e. the compatibility of the anti-abuse rules with the EU law. As the scope of these rules extends to relations with third countries, they may contradict the obligation arising from the tax treaties concluded between the Member States participating in the CCCTB and third countries. In the next section, the areas of conflict will be highlighted.

### ***Implementing anti-abuse rules between the CCCTB Member States***

In the relations between the CCCTB Member States, the CCCTB Directive does not clarify whether anti-abuse rules are applicable or not. However, it seems that the application of anti-abuse rules would not be needed, as all the profits of a group’s members will be consolidated regardless of the Member States in which they are sourced, and so the possibilities of tax avoidance are not likely to occur. However, abusive practices could occur at the level of the factors of formulary apportionment, it depending on the choice of these factors. The factors of the current formulary apportionment are not easy to manipulate; for instance, under the labour, capital and sales factors, attracting profits into one jurisdiction inside the consolidation area would not result in a rise of the share of the corporate tax apportioned to that jurisdiction.<sup>863</sup>

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<sup>863</sup> Marcel Gerard & Edoardo traversa, ‘Supplementing Consolidation and Apportionment with Anti-abuse Provisions’ in Lang, M. et al, ‘*Tax Treaties: Building Bridge between Law and Economics* (2010, IBFD), p.194.

#### 4.4.1 General anti-abuse rules in the CCCTB

In this section the establishment and the outlines of the general anti-abuse rules in the CCCTB are set out. The sufficiency of the application of general anti-abuse rules within the EU and in relation to third countries is addressed. In this regard, the key principles developed by the ECJ, which are related to the application of the GAAR, are highlighted.

The CCCTB Directive lays down for a GAAR concept. It explicitly states '*that artificial transactions carried out for the sole purpose of avoiding taxation shall be ignored for the purpose of calculating the tax base*'.<sup>864</sup> In other words, this provision targets the transactions or *series of transactions*<sup>865</sup> that do not contain an economic substance.<sup>866</sup> In this context, the test of '*sole purpose*' can be considered as more explicit and narrower than other tests used in other Directives, such as the EU Merger Directive. The latter applies a '*main purpose test*' according to which if the '*principal objective*' or one of the '*principal objectives*' for carrying out the transactions is tax avoidance, these transactions will be ignored for the purpose of calculating the tax base.<sup>867</sup> Therefore, the '*sole purpose*' test in the CCCTB Directive is straightforward. Moreover, stipulating that the transactions have to be carried for the exclusive purpose of avoiding taxation is considered to be in line with the ECJ's principle of '*wholly artificial arrangements*'.<sup>868</sup>

The ECJ conferred more unambiguous guidance on the criteria for detecting abusive practice, i.e. wholly artificial arrangements.<sup>869</sup> The ECJ held that in determining whether or not the economic reality exists and thus considering an establishment to be genuine, the economic reality must be based on objective factors, which are

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<sup>864</sup> Art. 80 of the CCCTB Directive; for detailed discussion of the GAAR operation see William I. Innes, Patrick J. Boyle, Joel A. Nitikman, *The Essential GAAR Manual: Policies, Principles and Procedures* (CCH Canadian Limited 2006), p.113 et seq

<sup>865</sup> The phrase of '*series of transactions*' is not defined in the CCCTB Directive, but it usually defined as the one that '*include related transaction or events completed in contemplating of the series*', see William I. Innes, Patrick J. Boyle, Joel A. Nitikman, *The Essential GAAR Manual: Policies, Principles and Procedures* (CCH Canadian Limited 2006), p.18.

<sup>866</sup> European Commission, '*Anti-Abuse Rules in the CCCTB*', (30 August 2010, CCCTB/RD\004\doc\en),p.4.

<sup>867</sup> Petrosovitch, Katrina, '*European Union - Abuse under the Merger Directive*', *European Taxation*, Vol. 50, No. 12, 2010, pp.558-567, at 562.

<sup>868</sup> *Ibid*, p.563.

<sup>869</sup> Petrosovitch, Katrina, '*European Union - Abuse under the Merger Directive*', *European Taxation*, Vol. 50, No. 12, 2010, pp.563.

discoverable by third parties.<sup>870</sup> The objective factors include, in particular, the physical existence in terms of premises, staff and equipment.<sup>871</sup> The ECJ added that the genuine economic activity should be reflected in these objective factors, so if the establishment is seen as factitious, which could occur, in particular, in the case of a “letterbox” or front subsidiary, then the establishment practice must be regarded as a wholly artificial arrangement.<sup>872</sup>

Moreover, in determining what constitutes ‘wholly artificial arrangements’, the ECJ pointed out several factors that do not of themselves suffice to constitute an abusive practice, i.e. ‘wholly artificial arrangements’. One of these factors is that the mere fact that a resident company establishes a subsidiary in another Member State does not, of itself, necessarily entail tax avoidance, since the company will in any event be subject to the tax legislation of the State of establishment.<sup>873</sup> Similarly, the ECJ has explicitly confirmed that a tax-induced subsidiary establishment in another Member State is legitimate, as long as it is a selection for more favourable tax legislation.<sup>874</sup> The ECJ has also held that the fact that the activities were carried out by a company established in another Member State which could be pursued by the taxpayer from within the territory of its home Member State does not warrant the conclusion that there is a wholly artificial arrangement.<sup>875</sup> In this context, despite these factors being determined in relation to specific anti-abuse rules such as CFC rules and thin capitalisation, it is relevant to the GAAR in the CCCTB which targets only the wholly artificial arrangements.

Where tax avoidance in the form of *wholly artificial arrangements* is evident, the GAAR applies. Consequently, the taxpayer is penalised, as the artificial transactions in the calculations of the tax base are disregarded, unless evidence for genuine commercial activities is provided.<sup>876</sup> This means that the GAAR mechanism contains an escape

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<sup>870</sup> ECJ C-196/04 *Cadbury Schweppes*, 12 September [2006] ECR I-07995, para.67. See also C-341/04 *Eurofood IFSC* [2006] ECR I-3813, para.66.

<sup>871</sup> ECJ C-196/04 *Cadbury Schweppes*, [2006] ECR I-07995, para. 67. See also C-341/04 *Eurofood IFSC* [2006] ECR I-3813, paras. 34 and 35

<sup>872</sup> ECJ C-196/04 *Cadbury Schweppes*, [2006] ECR I-07995, para. 68.

<sup>873</sup> ECJ C-264/96, *ICI v Colmer*, 16 July [1998] ECR I-04695, para. 26 on the interpretation of Arts. 5 and 52 of the EC Treaty.

<sup>874</sup> ECJ C-196/04 *Cadbury Schweppes*, [2006] ECR I-07995, para. 37.

<sup>875</sup> *Ibid*, Para. 69.

<sup>876</sup> Art.80 of the CCCTB Directive.

clause whereby the taxpayer is able to refute this outcome of the GAAR application by introducing evidence of the genuineness of the commercial transactions. Genuine commercial activities exist where the taxpayer could have chosen between two or more possible transactions which have the same commercial result, but produce different taxable amounts.<sup>877</sup> It follows that, to the extent that tax planning incorporates elements of a genuine conduct of trade, it is in principle allowed, regardless of whether a scheme is in essence designed to mitigate tax.<sup>878</sup>

Additionally, it has been considered that the objective of minimising one's tax burden is *per se* a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits.<sup>879</sup> In other words, in so far as taxpayers have not entered into abusive practices, Member States cannot hinder the exercise of the rights of freedom of movement simply because of lower levels of taxation in other Member States.<sup>880</sup> Therefore, the CCCTB's GAAR has the objective of curbing purely artificial transactions as defined by the ECJ. As regards the hierarchy between the GAAR and other specific anti-abuse rules, this will be considered after examining the scope of application of the latter.

#### **4.4.2 Applying specific anti-abuse rules in the context of the CCCTB in relation to third countries**

Basically, the anti-abuse rules presented in the CCCTB Directive, which target certain abusive situations, are: the switch-over clause (as demonstrated above), disallowance of interest deductions (thin capitalisation rules), and provisions on Controlled Foreign Corporation (CFC) legislation. Evidently, insofar as the specific anti-abuse rules are concerned in the context of the CCCTB, detailed provisions are given by the CCCTB

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<sup>877</sup> Art.80 of the CCCTB Directive.

<sup>878</sup> European Commission, Anti-Abuse Rules in the CCCTB, (30 August 2010, CCCTB/RD\004\doc\en),p.4.

<sup>879</sup> Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue* [2008] ECR I-02875, for more on this analysis on this case see Zoë Prebble and John Prebble, 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law', *Bulletin for International Taxation*, April 2008, p.151; European Commission, 'The Application of Anti-abuse Measures in the Area of Direct Taxation –within the EU and in relation to Third Countries' (Communication) COM(2007) 785 final, p.3.

<sup>880</sup> ECJ C-294/97, *Eurowings Luftverkehrs AG* [1999] ECR I-07447, para.44.



Directive on the application of these rules vis-à-vis third countries.<sup>881</sup> It goes without saying that these rules will work in conjunction with the general anti-abuse rules with respect to third countries.<sup>882</sup> However, whether within the EU generally, or precisely between CCCTB-Member States and non-CCCTB-Member States (if there were such) is not explicitly stated in the CCCTB Directive.

#### **4.4.2.1 The Controlled Foreign Corporation (CFC) legislation in the CCCTB**

CFC rules are a critical measure included in the CCCTB system as a specific anti-avoidance provision. Before examining the sufficiency of the CFC rules in protecting the common tax base, it is imperative to take a general overview of the CFC legislation in the international context.

##### **4.4.2.1.1 CFC rules from an international perspective**

In international tax law, if a country taxes its residents on a worldwide basis and a resident taxpayer holds shares in a foreign company, profits that arise in the foreign company, which is regarded as a separate entity, are not taxed in the residence country of the shareholder until such profits are remitted, i.e. when the shareholder receives the dividends or disposes of its shares in the foreign company.<sup>883</sup> This means that the domestic taxation in the residence country of the shareholder is postponed, a process referred to as '*tax deferral*'.<sup>884</sup> This deferral is beneficial for the shareholders in two cases: firstly, where the foreign tax payable by the foreign company is lower than the tax payable by the shareholder in its country of residence; and, secondly, where the benefit is even greater when the foreign corporation is subject to a low tax system or special low tax regime in the location where it is established, e.g. in a third country.<sup>885</sup>

It follows that the '*taxation deferral*' would give incentives to residents to shift income to low tax territories and to accumulate such income therein instead of repatriating such income to the residence country. The abusive practice of income-shifting into low tax jurisdictions, by the use of a controlled foreign company, would entail the need to

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<sup>881</sup> Arts.81, 82 of the CCCTB Directive.

<sup>882</sup> European Commission, Anti-Abuse rules in the CCCTB' (30 August 2010, CCCTB/RD\004\doc\en),p.4.

<sup>883</sup> OECD, Controlled Foreign Company Legislation (1996), p.16.

<sup>884</sup> Hans-Jorgen, Ulrich Scheuerle and Markus Stefaner, 'General Report', in 'Michael Lang, (ed.) *CFC Legislations, Tax treaties and EC Law* (2004 Kluwer Law International), pp. 15, 16.

<sup>885</sup> OECD, Controlled Foreign Company Legislation (1996), p.15.

protect the domestic tax base against tax erosion.<sup>886</sup> Therefore, the CFC legislation is designed to achieve the objective of protecting the domestic tax base from erosion, which results from the outflow of capital to low tax territories. The main effect of the CFC rules implies taxing the resident shareholder on its pro rata share of some or all of the undistributed income of the CFC.<sup>887</sup> In accordance with this objective of the CFC rules, it is referred to as an anti-deferral regime. However, the CFC rules recently had the aim of preventing income from being deflected into jurisdictions which apply a preferential tax regime.<sup>888</sup>

On the importance of CFC legislation, since the obstacles to the free movement of capital between the countries involved have been removed and the businesses are operating internationally, the objective of such rules has become a concern for many countries.<sup>889</sup> Moreover, as the OECD encourages the Member States to adopt anti-abuse tax rules, it was concluded by the OECD's Committee on Fiscal Affairs that the CFC legislation is indispensable.<sup>890</sup> Additionally, the OECD recommended countries that do not incorporate CFC rules into their legislation to 'consider implementing them and those countries that have such rules to ensure that they apply in a manner consistent with the desirability of curbing harmful tax practices'.<sup>891</sup>

Many countries, including Member States in the EU, adopted certain CFC rules in their national legislation.<sup>892</sup> Although the policy background, the main structures and the underlying objectives set for the CFC legislation are similar in most of these countries,<sup>893</sup> there is a substantial variation in respect to the technical details across different countries. These variations arise in relation to the criteria used in determining the application of the CFCs, such as control (the ownership requirement), the activities,

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<sup>886</sup> For more discussion on the 'deferral' principle see OECD, *Controlled Foreign Company Legislation* (1996), P.16.

<sup>887</sup> Michael Lang, *CFC Legislations, Tax Treaties and EC law* (2004 Kluwer Law International), p.17.

<sup>888</sup> The Deferral of Income Earned through U.S. Controlled Foreign Corporations- A Policy Study (2000) Office of Tax Policy Department of the Treasury, p.3.

<sup>889</sup> *Ibid*, p.61.

<sup>890</sup> OECD, *Controlled Foreign Company Legislation* (1996), p.97.

<sup>891</sup> OECD, '*Harmful Tax Competition –An Emerging Global Issue*', OECD, 1998, p.40.

<sup>892</sup> Based in the year in which the CFC rules is introduced, these countries in chronological order are: Germany (1972); France (1980);United Kingdom(1984); Sweden(1990); Norway (1992); Finland (1995); Spain (1995); Portugal (1995); Denmark (1995); Hungry (1997); Estonia (2000); Italy (2000), see, Georg Kofler, 'CFC Rules', in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base*( Linde, 2008),p.727.

<sup>893</sup> For general overview see Jacques Malherbe, 'Controlled Foreign Corporation in the EU after Cadbury Schweppes', *Tax Management International Journal*, Vol. 63, No.12, 2007, p. 607.

and the type of income of the CFC; for instance, some countries distinguish between active and passive income. The methods used to define a *low taxation* regime also differ, ranging from objective criteria such as a jurisdictional approach to a system based on a list of designated countries, or a combination of both methods.<sup>894</sup> Moreover, regarding the basis for taxing the shareholders on the undistributed income of the foreign company, in theory the CFC rules are framed according to either the ‘*deemed dividend*’ approach or the ‘*piercing the corporate veil*’ approach. Under the first approach, the undistributed profits are deemed to have been remitted, while according to the second approach, the sheltered profits are deemed to have arisen in the hands of the shareholder.<sup>895</sup>

#### **4.4.2.1.2 The need for CFC rules within the CCCTB regime**

As mentioned earlier, the CCCTB resident taxpayers are taxed on a *worldwide* basis: the inbound payments such as passive income (interest and royalties) and any other income taxed at source are taxable with a credit relief for foreign taxes.<sup>896</sup> Dividends, foreign permanent establishment income and capital gains are tax exempt.<sup>897</sup> Given the above tax treatment, the taxpayer may easily escape worldwide taxation through the use of a foreign corporation: the profits of a foreign corporation as passive income will not be taxable in the CCCTB jurisdiction until they are distributed, and they will be subject to tax only in the country where the foreign company is taxable. Thus, the taxpayer can avoid taxation and shift income to a low tax jurisdiction. Such practices would, however, cause the erosion of the common tax base, and therefore, certain measures for the tax base protection would be required.<sup>898</sup> Thus, the possibility of introducing a common CFC rule was suggested and subsequently adopted in the CCCTB Directive.<sup>899</sup>

Moreover, although CFC rules operate in most of the EU-Member States to curb the taxation deferral on passive income derived by foreign entities situated in a low-tax

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<sup>894</sup> OECD, *Controlled Foreign Company Legislation*, 1996, p.42.

<sup>895</sup> Michael Lang et al, *CFC legislations, Tax treaties and EC law* (2004 Kluwer Law International), p.23.

<sup>896</sup> Art. 76 of the CCCTB Directive.

<sup>897</sup> Art. 11 of the CCCTB Directive.

<sup>898</sup> European Commission, ‘Possible Elements of a Technical Outline’, (26 July 2007, CCCTB/WP057/doc/en), para. 127.

<sup>899</sup> Art. 81 of the CCCTB Directive

territories,<sup>900</sup> the area of specific anti abuse measures, such as CFC rules, if left to the individual action of the Member States' national legislation, would present a risk of inconsistent provisions and undesirable complication of the CCCTB. Therefore, agreeing on a common approach in respect to the CFC rules is necessary.<sup>901</sup> Additionally, since the objective of the CFC rules is to protect the domestic tax base against erosion,<sup>902</sup> the provisions included in the CCCTB Directive should aim to achieve the same objective as in the domestic legislations of the EU-Member States.<sup>903</sup> Before examining the objective of the CFC rules in the CCCTB, however, it is necessary to determine their territorial scope.

#### **4.4.2.1.3 The intended scope of a Common CFC regime**

In respect to the scope of the CFC rules, it should be clarified whether the same or different arrangements of the CFC should apply to non-CCCTB Member States and third countries.

##### **4.4.2.1.3.1 CFC rules in the relation between CCCTB Member States and non-CCCTB Member States**

As regards the relation between CCCTB Member States and other EU countries, the scope of application of the anti-abuse rules must be tested against EU law provisions, in particular the free movement of capital and the freedom of establishment provisions.<sup>904</sup> It follows that the application of specific anti abuse rules within the EU, in particular CFC rules, are applicable in the EU but in accordance with the ECJ's ruling in respect to the above freedoms.<sup>905</sup> This because the ECJ provides guidelines on the design of anti-abuse rules applicable within the EU.<sup>906</sup>

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<sup>900</sup> Resolution of the Council and the representative of the Governments of the Member States, meeting within the council of 1 December 1997 on a code of conduct for business taxation, 1998, OJ C2,p. 2 et seq.

<sup>901</sup> European Commission, 'International Aspects in the CCCTB' (CCCTB\WP\019\doc\en), para.43.

<sup>902</sup> European Commission, 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en),p.12.

<sup>903</sup> European Commission, 'The Application of Anti-abuse Measures in the Area of Direct Taxation – within the EU and in relation to third countries'(Communication) COM(2007) 785 final , p.6.

<sup>904</sup> European commission, Co-ordinating Member States' direct tax systems in the Internal Market, COM (2006) 823 final.p.5.

<sup>905</sup> European Commission, Anti abuse Rules, Brussels, 26 March 2008, CCCTB/WP065\doc\en, para.29.

<sup>906</sup> In several cases, the ECJ considered various anti-abuse rules to determine whether they are consistent with the freedom of establishment, this include for example Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, [2002] ECR I-11779; ECJ C-9/02, *De Lasteyrie du Saillant v. Ministère de l'Economie, des Finances et de l'Industrie*, [2004] ECR I-2409.

The ECJ generally, in several cases,<sup>907</sup> adopts a restrictive stance in respect to the compatibility of the anti-abuse rules with the EU law.<sup>908</sup> This position is that, among the Member States of the EU, taxpayers are free to establish and operate their businesses in any Member State they prefer, and even if that Member State operates a more favourable tax system, a Member State has no right to restrict such freedom. Anti-abuse rules are only applicable to abusive arrangements, and taxpayers must have the chance to prove that the transactions into which they have entered are genuine business activities and not wholly artificial arrangements.<sup>909</sup>

On the consistency of the CFC rules with EU law, the ECJ held in 2006 that taxing the CFC's income is not compatible with the exercise of freedom of establishment, because it prevents a resident company from establishing itself, by way of subsidiaries, in another Member State in which such subsidiaries are subject to a lower level of taxation. Therefore, this tax treatment, i.e. inclusion of profits of a CFC in the domestic tax base, contradicts the freedom of establishment (Art. 49 of TFEU) and the free movement of capital (Art.63 of TFEU).<sup>910</sup> However, the ECJ added that the restriction on the freedom of establishment is only justified if the CFC rules eliminate conduct involving the creation of wholly artificial arrangements which do not reflect economic reality.<sup>911</sup> Furthermore, in other cases, CFC rules were denied and considered to be contradicting the EU law because they were not targeting only the wholly artificial arrangements.<sup>912</sup>

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<sup>907</sup> See for example ECJ C-28/95, *Leur Bloom* [1997] ECR I-04161; C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Tax)*, [1998] ECR I-4695

<sup>908</sup> Generally see Otmar Thommes, 'CFC legislation and EC Law', *Intertax*, Vol. 31, 2003, pp.188-189.

<sup>909</sup> ECJ Case C-201/05 *CFC GLO* [2008] ECR I-02875, para. 82.

<sup>910</sup> ECJ, C-196/04, *Cadbury Schweppes V. Commissioners of Inland revenues* [2006] ECR I-7995, paras, 46, 51.

<sup>911</sup> ECJ, C-196/04, *Cadbury Schweppes V. Commissioners of Inland revenues* [2006] ECR I-7995, paras. 55 and 75.

<sup>912</sup> *Videophone 2 v. HMRC* [2008] EWHC 1569 (Ch), Cited in Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.77; The CEA position on the CCCTB: Possible Elements of a Technical Outline, 7 December 2007, p.7.

Therefore, the application of CFC rules, in the context of the CCCTB, would be consistent with EU law as long as they target only *the wholly artificial arrangements*.<sup>913</sup> It is argued<sup>914</sup> that the approach set by the ECJ, which limits the scope of the CFC rules to ‘the wholly artificial arrangements’ might narrow the application of CFC rules and thus the objective of discouraging the legal migration of passive income outside the consolidated tax base would not be attained.<sup>915</sup> Furthermore, proving the genuineness of the business activities would be achieved through a case-by-case approach<sup>916</sup> which increases the difficulty of applying the CFC rules.<sup>917</sup>

Having considered the landmark decision in *Cadbury Schweppes*, which significantly limits the scope of the CFC rules to ‘*wholly artificial arrangements*’,<sup>918</sup> this would not affect the competitiveness of the CCCTB companies, as non-CCCTB countries with a lower tax rate would not face the burden of additional corporate taxation on their domestic investments undertaken by business taxable under the CCCTB.<sup>919</sup> Furthermore, since the exemption method, which applies to some types of income derived from non-CCCTB Member States, is provided in the CCCTB Directive, it is perceived that it would be a pragmatic solution to keep the possible anti-avoidance rules, especially the CFC rules, to a minimum in order not to nullify the positive effect of the exemption method, that is, the competitiveness of CCCTB companies. This solution seems to be workable in the light of the decision in *Cadbury Schweppes*.<sup>920</sup>

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<sup>913</sup> ECJ C-298/05, *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* [2007] I-10451 and for a commentary on this case see Tom O’ Shea, ‘German CFC rules held compatible with EU law’ *Tax Note International*, Vol. 48, December 2007, pp.1-5.

<sup>914</sup> Zoë Prebble and John Prebble, ‘Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law’, *Bulletin for International Taxation*, April 2008, p.163.

<sup>915</sup> For more discussion on CFC rules and community law see Georg Kofler, ‘CFC rules’, in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), pp.734-739.

<sup>916</sup> Gerard T.K Meussen, ‘Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States’, *European Taxation*, January 2007, pp.13,18.

<sup>917</sup> Marcel Gerard & Edoardo Traversa, ‘Supplementing Consolidation and Apportionment with Anti-abuse Provisions’ in Lang, M.et al., *Tax Treaties: Building Bridge between Law and Economics*, (2010, IBFD), p.199; Anno Rainer, ‘ECJ restricts Scope of CFC Legislations’, *Intertax*, Vol. 34, 2006, pp. 636-638.

<sup>918</sup> Georg Kofler, ‘CFC Rules’, in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base*, (Linde, 2008), p.729.

<sup>919</sup> International Chamber of Commerce, *An optional Common Consolidated Corporate Tax Base in Europe: Implications for Businesses Worldwide*, 11 June 2007, p.3, available at <[www.iccindiaonline.org/policy\\_state/Tax.pdf](http://www.iccindiaonline.org/policy_state/Tax.pdf)> accessed 15 March 2013.

<sup>920</sup> European Business Initiative on Taxation, *EBIT contribution to the commission on the CCCTB*-November 2006, P.6.

#### 4.4.2.1.3.2 Implementing CFC rules in relation to third countries

Knowing that the CFC rules are relevant to the taxing right of a company established in third countries, i.e. foreign company, and controlled by a resident taxpayer (either an individual or a company),<sup>921</sup> their application vis-à-vis third countries is to be tested only from a freedom of establishment perspective.<sup>922</sup> According to ECJ case law, ‘the resident shareholder is considered to be practising the right of *establishment* when the capital, which is held in the company established in another Member State, gives [that shareholder] a definite influence over the company's decisions and allows him to determine its activities’.<sup>923</sup> Seemingly, this would be the case in the CCCTB, as its CFC rules are applicable when the shareholder taxpayer holds more than 50% of voting rights or capital of the foreign company.<sup>924</sup> This threshold is considered to constitute a sufficient influence over the foreign company’s decisions.<sup>925</sup> Therefore, the application of the CCCTB’s CFC rules would impact on such a shareholder’s ability to establish itself in third countries, and thus the implementation of such rules in relation to third countries should be measured against the freedom of establishment under Art. 49 of the TFEU.<sup>926</sup>

However, the freedom of establishment does not apply in relation to third countries, due to the fact that the EU law does not oblige the Member States to prevent discrimination toward third countries. In this respect, discrimination would not be an issue in the application of CFC rules to a controlled company resident in a third country.<sup>927</sup> Thus, the CCCTB’s CFC rules will apply to third countries without any restrictions; this position is in accordance with the European Commission’s stance in this respect.<sup>928</sup>

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<sup>921</sup> Art.82 (1) of the CCCTB Directive.

<sup>922</sup> Christiana HJI Panayi, ‘The Fundamental Freedoms and Third Countries: Recent Perspective’, *European Taxation*, November 2008, pp.571-582, at574.

<sup>923</sup> ECJ, C-196/04, *Cadbury Schweppes V. Commissioners of Inland revenues* [2006] ECR I-7995, Para.31; ECJ Case C-251/98, *C. Baars and Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem* [2000] ECR I-02787, Para.20.

<sup>924</sup> Art.82 (1) (a) of the CCCTB Directive.

<sup>925</sup> ECJ, C-196/04, *Cadbury Schweppes V. Commissioners of Inland revenues* [2006] ECR I-7995, Para. 6 and 32.

<sup>926</sup> ECJ Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emmendingen* [2007] ECR I-03775, Para.200.

<sup>927</sup> ECJ Case C-264/96, *Imperial Chemical Industries plc (ICI) and Kenneth Hall Colmer* [1998] ECR I-04695, para.34.

<sup>928</sup> European Commission, ‘The Application of Anti-abuse Measures in the Area of Direct Taxation – within the EU and in relation to third countries’(Communication) COM(2007) 785 final , p.8.

On the other hand, if CCCTB anti-abuse rules affect transactions other than the ones between companies where one has definite influence over the other (i.e. the case of the CCCTB's CFC) or intra-group loans (i.e. the thin capitalization rules in the CCCTB), in such cases, their application would impinge upon the free movement of capital.<sup>929</sup> Since under Art. 63(1) of the TFEU, the free movement of capital<sup>930</sup> is applicable in relation to third countries, the CFC rules would need to comply with that Article, and could only be applied to '*wholly artificial arrangements*' where there is an adequate information exchange relationship with the third country concerned.<sup>931</sup>

Therefore, on the compatibility of CCCTB anti-abuse rules with EU law, a distinction has to be made between the application of such rules within the EU when the four freedoms apply, and in relation to third countries where only the free movement of capital is applicable. Where the anti-avoidance rules apply within the EU (between the CCCTB Member States and other EU countries) they fall under the scope of freedom of establishment and free movement of capital. In aligning the anti-abuse rules with these freedoms, the ECJ restricted their application to wholly artificial arrangements only. The CCCTB Directive does not explicitly state whether the specific anti-abuse rules apply in intra-community transactions or not. This could imply that these rules would not be even applied to '*wholly artificial arrangements*' in the EU, as the CCCTB Directive provides for a GAAR for eliminating purely artificial transactions. In any case, the CCCTB position in this regard does not contradict the EU law. In relation to third countries, however, the application of the specific anti-abuse rules does not infringe the free movement of capital between Member States and third countries, thus these rules are applicable towards third countries without any restriction.<sup>932</sup> Therefore, in the context of the CCCTB, the applications of specific anti-abuse rules within the EU

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<sup>929</sup> Christiana HJI Panayi, 'The Fundamental Freedoms and Third Countries: Recent Perspective', European Taxation, November 2008, pp.571-582, at574; For discussion on the relationship between free movement of capital and freedom of establishment see Axel Cordewener, Georg W. Kofler, Clemens Philipp Schindler, 'Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with Lasertec, A and B and Holböck', European Taxation, August 2007, pp.371-376.

<sup>930</sup> The TFEU does not define the free movement of capital, but a non-exhaustive list is provided in Annex I of Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty OJ L 178, p.5. Under para.1 of such Annex, capital movement includes for example direct investment, operation in securities, loans and credit, operation in securities and other transactions.

<sup>931</sup> However, it argued that the third countries should not benefit from the protection of the EU law as under the capital free movement see Christiana HJI Panayi, 'The Fundamental Freedoms and Third Countries: Recent Perspective', European Taxation, November 2008, p.582.

<sup>932</sup> European Commission, 'The Application of Anti-abuse Measures in the Area of Direct Taxation – within the EU and in relation to third countries'(Communication) COM(2007) 785 final , p.8.



and in relation to third countries are consistent with the EU law. In relation to third countries, anti-avoidance rules may be restricted by double tax treaties in place with the third countries concerned. All in all, the common CFC regime of the CCCTB applies to third countries only.<sup>933</sup> The scope of the CFC rules includes only the subsidiaries resident in third countries,<sup>934</sup> as the income of foreign permanent establishment is subject to the switch-over clause, which produces the same result as the CFC rules.

In the following section, the structural features and the objective of the CCCTB's CFC rules which are applicable to third countries will be analysed.

#### **4.4.2.1.4 The main features of CFC rules in the CCCTB**

In accordance with the CCCTB Directive, specific issues related to the design of the CFC regime will be analysed below. These issues include the categories of income the regime should cover, the control test provided, whether it applies only in the case of undistributed profits in low tax rate jurisdictions or applies generally to certain income types regardless of the actual distribution, and whether such a regime would be seen as an alternative or an adjunct to a switch-over mechanism.<sup>935</sup> In addition, the concept of the CFC rules will be determined.

##### **4.4.2.1.4.1 A foreign company controlled by a resident shareholder**

A company can qualify as a CFC, and consequently become subject to CFC rules, when it is resident in a third country and is *controlled* by a *taxpayer* resident in the CCCTB jurisdiction. This implies that the CCCTB's CFC rules apply to the company resident in a third country which is treated as a separate taxable entity for domestic tax purposes. In relation to the control criterion, it is defined as<sup>936</sup> holding directly or indirectly a participation of more than 50% of the voting rights, or owning more than 50% of the capital or having the right to receive more than 50% of the profits of the third country entity.<sup>937</sup> The taxpayer may be controlling the foreign company by itself or in concert

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<sup>933</sup> See Art.82 (a) of the CCCTB Directive

<sup>934</sup> Art 82(1) of the CCCTB Directive; European Commission, 'Anti-abuse Rules in the CCCTB' (CCCTB/RD\004), para.20.

<sup>935</sup> European Commission 'CCCTB: Possible Elements of a Technical Outline', (26 July 2007, WP057/doc/en), Paras. 127 and 129.

<sup>936</sup> European Commission, 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en),Para.19.

<sup>937</sup> Art.82 (a) of the CCCTB Directive.

with its associated enterprises. In this respect, the taxpayer and its associated enterprise constitute a *shareholder*.

The preference for the above fixed threshold rather than a case-by-case approach is an appropriate approach as has been suggested <sup>938</sup> and is also used <sup>939</sup> regarding the definition of associated enterprises. The CCCTB Directive considered that the required minimum quota of 50% of either the capital or voting rights is sufficient to prove the shareholder's control of the foreign company. Additionally, the alternative required minimum quota of 50% of the profits entitlement would refer to the extent of the shareholder's influence over the foreign company.<sup>940</sup>

#### **4.4.2.1.4.2 Low taxation**

Low taxation is another major criterion for the application of CFC rules. A foreign company is subject to CFC rules where its income is taxed under a low tax rate in a third country. This approach is referred to as 'designated jurisdiction',<sup>941</sup> and under this approach, which is applied internationally, the CFC rules are applied only to the foreign company where their profits are subject to a substantial low level of foreign tax.<sup>942</sup> It seems that the CCCTB Directive follows such an approach as it provides that an entity resident in a third country will be subject to CFC rules where, under the general regime in the third country, profits are taxable at a statutory corporate tax rate that is lower than 40% of the average statutory corporate tax rate applicable in the Member States, and the entity is subject to a special regime that allows for a substantially lower level of taxation than that of the general regime.<sup>943</sup> In this regard, the comparison between the nominal tax rates as an indicator of a low tax system is generally easy to apply.

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<sup>938</sup> European Commission, 'Possible Elements of a Technical Outline' (CCCTB/WP057/doc/en), Para. 78.

<sup>939</sup> Art. 78 of the CCCTB Directive.

<sup>940</sup> Georg Kofler, 'CFC Rules' in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), p.745.

<sup>941</sup> *Ibid*, p.747.

<sup>942</sup> For more on other applicable approaches see Michael Lang, Hans-Jorgen, Ulrich Scheuerle and Markus Stefaner, *CFC legislations, Tax treaties and EC law* (2004 Kluwer Law International), p.19.

<sup>943</sup> Art.82 (b) of the CCCTB Directive.

#### **4.4.2.1.4.3 Tainted income**

The CCCTB's CFC rules also apply to the foreign company where more than 30% of its accruing income is 'tainted'.<sup>944</sup> Tainted income falls into certain categories. In particular, income of a certain category is considered as tainted income where more than 50% of such income is driven from transactions between the CFC and the taxpayer or its associated enterprise.<sup>945</sup> For these purposes the CCCTB Directive lists the categories of tainted income,<sup>946</sup> such as interest or any other income created by financial assets; royalties or any other income generated by intellectual property; dividends and income from the disposal of shares; income from insurance; banking and other financial activities; income from movable property or from immovable property, unless a current double tax treaty states otherwise.<sup>947</sup> It can be noted that the categories of tainted income specified above are mainly passive income. Therefore, according to this condition, the CFC is defined based on the nature of the income earned by the company, meaning that when more than 30% of the total income earned by the company is passive income, the company would be considered to be a CFC.<sup>948</sup>

In addition to the above conditions, the CCCTB Directive stipulates that the foreign company will also be subject to CFC rules where its principal class of shares is not regularly traded on one or more recognised stock exchanges.<sup>949</sup>

#### **4.4.2.1.5 Consequence of applying the CFC rules**

Once all the above requirements are fulfilled, the entity resident in a third country qualifies as a CFC, and consequently the CFC legislation applies, meaning that all of the non-distributed income of the CFC is taxed in the hands of the CCCTB taxpayer,<sup>950</sup> but the tax is imposed only on the taxpayer's pro rata share of such income. The income inclusion is carried out in the year at which the tax year of the CFC ends.<sup>951</sup> For

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<sup>944</sup> Art.82 (c) of the CCCTB Directive

<sup>945</sup> Art.82 (3) of the CCCTB Directive

<sup>946</sup> For the definition of tainted income see John E. Rogers & Edward P. Lemanowicz, 'Limits on the Use of Low-Tax Regimes by Multinational Business: Current Measures and Emerging Trends', 2000, p.8, available at < [www.ifausa.org/dman/Document.phx/.../RogersLemanowicz.pdf](http://www.ifausa.org/dman/Document.phx/.../RogersLemanowicz.pdf) > accessed 20 August 2013.

<sup>947</sup> Art.82 (3) of the CCCTB Directive.

<sup>948</sup> European Commission, 'Anti-abuse Rules', (CCCTB/WP065\doc\en), para.34.

<sup>949</sup> See Art.82 (d) of the CCCTB Directive

<sup>950</sup> European Commission, 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en), Para.30; Art.82 (1) of the CCCTB Directive

<sup>951</sup> Art.83 (2),(3) of the CCCTB Directive

the purposes of determining the amount of the CFC income which is taxed in the hands of the resident shareholder, the CFC net income is computed according to the provisions of the CCCTB Directive, on the calculation of the common tax base, hence the calculation rules of the third country tax system are not relevant.<sup>952</sup>

#### 4.4.2.1.5.1 Attributed income

In principle, there are two main approaches regarding the type of income that can be attributed to the resident shareholder of the CFC: the '*transactional approach*' and the '*entity approach*'.<sup>953</sup> Under the former, each item of the CFC income is individually tested in order to determine whether it should be attributed to the resident shareholder or not; among the criteria for such determination is the distinction between passive and active income. In contrast, the second approach only considers the CFC itself; the type of income does not have to be specified. Accordingly, under this approach, where certain conditions are fulfilled, e.g. residence in a tax haven, or low taxation, all the sheltered income of the CFC will be attributed to the resident shareholder.

Under the CCCTB's CFC rules, all non-distributed income will be included in the tax base of the taxpayer without any distinction between active and passive income. The CCCTB Directive appears to have adopted the *entity approach*, which has the advantage of reducing compliance and administrative costs. However, it is submitted that under this approach, if both tainted and non-tainted income accrue to the CFC, either the tainted income will escape tax or the non-tainted income will be taxable, and this would be undesirable. Thus, the transactional approach is seen to be more consistent with the anti-abuse concept.<sup>954</sup>

Since the CFC regime requires that the entire undistributed income of the CFC be included, in the tax base of the resident shareholders, the application of the CFC rules should not result in double taxation or lead to a higher taxation than in comparable domestic situations,<sup>955</sup> i.e. the same income can only be included once in the taxable

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<sup>952</sup> Art.83 (1) of the CCCTB Directive

<sup>953</sup> Linda Favi, National Report Italy', in Michael Lang, Hans-Jorgen, Ulrich Scheuerle and Markus Stefaner, '*CFC Legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p.349.

<sup>954</sup> Georg Kofler, 'CFC Rules' in , Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (eds.), *Common Consolidated Corporate Tax* , (Linde, 2008), p.746.

<sup>955</sup> European Commission 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en), p.7.

base. Therefore, the non-distributed CFC income that has been taxed by being included in the tax base of the resident shareholders should not be double taxed when the actual distribution is made. The CCCTB Directive provides for some relief measures to eliminate double taxation. It states that where the foreign entity subsequently distributes profits to the taxpayer, the amounts of income previously taxed according to the CFC rules are *deducted* from the tax base when calculating the taxpayer's tax liability on the distributed income.<sup>956</sup> Moreover, when computing the taxpayer's tax liability, the income received due to the disposal of shares in the CFC will be reduced by any undistributed amounts which have been already included in the tax base.<sup>957</sup> However, losses made by the CFC will not be included in the tax base of the taxpayer, but will be carried forward to future years.<sup>958</sup> Furthermore, the relief measures to eliminate double taxation do not include relief for *foreign taxes*; the Directive does not clarify how such relief should be provided.

#### **4.4.2.1.6 The concept of the CCCTB's CFC rules**

As the sheltered income of the CFC is attributed to the resident shareholder, however, the legal basis for such income attribution should be determined. There are two different theoretical approaches: the *piercing the veil* approach and the *deemed dividends* approach. According to the *piercing the veil* approach,<sup>959</sup> the income obtained by the CFC is attributed to the owner shareholders as if it is directly earned by the latter through the former. Only for tax purposes is the CFC disregarded as a separate taxable entity. Under the *deemed dividends* approach, the CFC is regarded as a separate taxable entity but its income is deemed to be distributed even without any actual profit distribution to the shareholders.<sup>960</sup>

It is not an easy task to decide which approach is endorsed by the CCCTB's CFC rules. This is because under both methods the CFC income is included in the tax base of the shareholder. However, a distinction can be drawn on the basis of some given criteria: in accordance with the deemed dividend approach, a sufficient percentage of ownership or

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<sup>956</sup> Art. 83(4) of the CCCTB Directive

<sup>957</sup> Art. 83(5) of the CCCTB Directive

<sup>958</sup> *Ibid.*

<sup>959</sup> It is also referred to as *Look-through approach*, also the deemed dividend approach is referred to as fictive distribution approach see Michael Lang et al, *CFC legislations, Tax treaties and EC law*(2004 Kluwer Law International), p. 35.

<sup>960</sup> Alexander Rust, 'CFC Legislation and EC Law' Intertax, Vol.36, 2008, p.492.

control of the CFC is required, since it is based on the assumption that the CFC is a separate legal entity, but its profit distribution policy is influenced by the shareholders. In contrast, a certain amount of holding requirement for the piercing the veil approach is not essential. Moreover, pursuant to the piercing the veil approach, profits and losses are included in the tax base of the shareholder, whereas under the deemed dividends approach losses are not attributed to the shareholder because they cannot be distributed. Another criterion is income attribution time: in the deemed divided approach, the CFC income is attributed to the shareholder at the time of the first distribution possibility; however, in the piercing the veil approach the income attribution is based on the time of income generation. As regards the calculation of the CFC income, according to the deemed approach the income calculation is carried out under the law of the residence country of the CFC. However, the law of the shareholder state is the basis for the income computation under the piercing the veil approach. Additionally, the foreign tax paid by the CFC is credited in the residence state of the shareholder under the piercing the veil approach, while the deemed divided approach allows for foreign tax deduction.

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Having considered these criteria, it seems that the CCCTB's CFC rules are drafted in accordance with the deemed dividend approach. First of all, the CCCTB's CFC rules apply only to subsidiaries resident in third countries.<sup>962</sup> A foreign *permanent establishment* does not qualify as a CFC, as it is treated as an *associated enterprise*, and the threshold for the control test under the definition of the associated enterprise is lower than the threshold of control that is required under the CFC regime. However, the permanent establishment will be subject to the switch-over clause under which the exempted income of a foreign permanent establishment, particularly dividends, is included in the tax base of the parent company. This is because the concept of *low-taxed* foreign income is identical under both the switch-over rules and the CFC rules. This means that when the CFC rules apply to a foreign entity, the switch-over clause will be activated as well. Therefore, the low-taxed income of a foreign permanent establishment will already be included in the tax base of the taxpayer in accordance with the switch-

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<sup>961</sup> Alexander Rust, 'CFC Legislation and EC Law' Intertax, Vol.36, 2008, p.492.

<sup>962</sup> Art. 28(1) of the CCCTB Directive; European Commission, 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en), para. 20.

over clause, not the CFC rules.<sup>963</sup> This proves that the separate tax subjectivity of the CFC is recognised in the CCCTB's CFC rules. Moreover, a minimum holding requirement is necessary:<sup>964</sup> the CFC losses are not included in the tax base, and the CFC income is attributed to the tax base of the taxpayer in the tax year in which the tax year of the CFC ends, i.e. the time of the first possibility for attribution.<sup>965</sup> These criteria on which the CFC rules in the CCCTB are drafted indicates that the deemed dividend approach is adopted by the CCCTB's CFC rules. The concept of the CFC rules is relevant in determining the potential conflict between these rules and the double tax treaties.

#### **4.4.2.1.7 An escape clause for CFC rules**

Unlike the thin capitalisation rules which will be discussed below, there is no general escape clause in the CFC rules.<sup>966</sup> The escape clause in the CFC rules is limited to third countries which are parties of the European Economic Area Agreement (EEA)<sup>967</sup> and with which there is an agreement on the exchange of information.<sup>968</sup> Accordingly, the escape clause gives a waiver to countries of the EEA with which exchange information to the standard of the Mutual Assistance Directive is in place.<sup>969</sup> This means that the escape clause in the CFC regime is not applicable in relation to non-EU countries even if there is an exchange of information mechanism in place.

#### **4.4.2.1.8 The CFC rule protects the common tax base**

Traditionally the CFC regime was applied so as to achieve the CEN policy, especially under tax systems that do not distinguish between passive and active income,<sup>970</sup> because domestic and foreign investment are treated equally. Since capital export neutrality is a corollary of the worldwide taxation principle, which is adopted by the CCCTB, the CFC

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<sup>963</sup> See KPMG Guide to CCCTB Part II, p.69 available at: <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/ccctb-guide-3.aspx> accessed 10 April 2012.

<sup>964</sup> See Art. 82(1) of the CCCTB Directive.

<sup>965</sup> See Art. 83(1), (3) of the CCCTB Directive.

<sup>966</sup> The escape clause in the thin capitalisation rules states that where there is an exchange of information mechanism with third countries, the thin capitalisation rules disapply, see below in 4.3.2.2.

<sup>967</sup> For general overview on the EEA's agreement see Marjaana Helminen, *EU Tax Law: Direct Taxation*, (IBFD 2011), p.30.

<sup>968</sup> Art. 82(3) of the CCCTB Directive

<sup>969</sup> European Commission, 'Anti-Abuse Rules in the CCCTB' (30 August 2010, CCCTB/RD\004\doc\en), Para.20.

<sup>970</sup> The Deferral of Income earned through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of Tax Treasury, December 2000, p.23 et seq.

appears to be introduced as a result of applying the worldwide taxation concept under the CCCTB. However, as mentioned earlier in this research,<sup>971</sup> the recent literature is tilting the scales in favour of source-based taxation and CIN policy<sup>972</sup> especially in the context of the CCCTB in the EU. Therefore, it can be seen that the CFC rules do not support the CIN; besides it is claimed that the CFC rules infringe tax sovereignty, cause harmful tax competition, and confuse deferral of tax and abuse.<sup>973</sup> This means that the CFC rules are not consistent with the CCCTB purpose of achieving CIN, plus they have a negative effect on the competitiveness of the CCCTB companies<sup>974</sup> as they interfere with the positive impact of the exemption method, which has been adopted by the CCCTB system.

On the other hand, there is some argument in favour of implementing the CFC rules in the CCCTB which could alleviate the above harsh criticism. Firstly, business income such as dividends and the proceeds from the disposal of shares are basically tax exempt under the CCCTB system, which implies that the CFC does not aim at achieving CEN in this respect. The CFC regime is presumably meant to tackle tax haven abuse and hence the protection of the common tax base as a prioritised objective. Moreover, as regards the passive income which is taxed under the CFC rules of the CCCTB, taxing such income is subject to strict conditions represented in the ownership requirement and low taxation jurisdiction, and this obviously implies the aim of the CFC rules, which is to prevent the migration of certain income to low-tax jurisdictions.

Moreover, the conditions for application of the CFC rules (foreign company controlled by resident taxpayer, situated in low-tax third country, tainted income) and its consequences (the attribution of the entire sheltered income, to the resident taxpayer) imply that it is designed to put a broad limitation on the deferral of tax on income realised through foreign subsidiaries and to prevent income migration to third countries through foreign entities. Therefore, the policy objective of the CFC rules in the CCCTB is to protect the common tax base by targeting tax avoidance and to prevent the

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<sup>971</sup> See Chapter t 3.4.5.

<sup>972</sup> Christiana HJI Panayi, *Double Taxation, Tax Treaties, Treaty Shopping and the European Community* (2007 Kluwer Law International), pp. 2-15.

<sup>973</sup> OECD, *Controlled Foreign Company Legislations* (1996), p.10.

<sup>974</sup> HM Treasury, *Reform of Controlled foreign Companies (CFC) policy principle document* (July 2009) available at < [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm) > accessed 30 August 2012.



migration of income, especially passive income, to tax havens; however, it does not contradict the very purpose of the CCCTB to achieve CIN policy.

#### **4.4.2.1.9 The relationship between CFC rules and the switch-over clause as anti-avoidance measures**

As regards the interaction between the CFC rules and the switch-over clause in the CCCTB, no reference has been made to such a relationship. However, it has been suggested that the CFC rules in the CCCTB would operate alongside the switch-over clause.<sup>975</sup> Moreover, since the switch-over clause is in the provision on the dealings between the CCCTB group and other entities outside the group, and the CFC rules are set out in the Chapter dedicated to anti-abuse rules, presumably each type of rule has a different purpose, which indicates that both rules would operate simultaneously.<sup>976</sup> Indeed, the switch-over clause applies to only to distributed dividends but the CFC rules apply to both distributed and undistributed income of the CFC.<sup>977</sup>

Since the CCCTB's CFC rules function as an adjunct and not as an alternative to the switch over-clause, this implies that if an income is already taxed according to the CFC rules it will have to be deducted from subsequent profit distributions, to avoid double taxation, i.e. the switch-over clause application will be avoided. Overall, both CFC rules and the switch-over clause are regarded as anti-avoidance measures.<sup>978</sup>

#### **4.4.2.2 Disallowance of interest deductions (thin capitalisation rules)**

Under certain conditions, the CCCTB Directive expressly *disallows the deduction of interest paid to an entity resident in third countries*. It has been confirmed that the disallowance deduction for interest paid into a third country is designed to attain the same goal as the *Thin Capitalisation* rules.<sup>979</sup> The main objective of these rules is to observe the application of the arm's length principle, thus maintaining a balanced allocation of taxing rights and the capability of preventing tax avoidance and tax

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<sup>975</sup> European Commission, 'Anti-Abuse Rules in the CCCTB', 30 August 2010, CCCTB/RD\004\doc\en), Para.18.

<sup>976</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.75.

<sup>977</sup> European Commission, 'Anti-abuse Rules', (26 March 2008, CCCTB/WP065\doc\en), para.28.

<sup>978</sup> See Georg Kofler, 'CFC Rules', in Michael Lang, et al. (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), p.748.

<sup>979</sup> Georg Kofler, 'CFC Rules', in Michael Lang, et al. (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), p.748.

abuse.<sup>980</sup> In order to understand how such rules function in the context of the CCCTB, a brief general overview of these rules will be outlined first.

Generally, the thin capitalisation rules had to be established in most countries because of the significant differences in the tax treatment between debt and equity financing methods.<sup>981</sup> This is clearly explained by General Advocate Geelhoed:

‘There are two main methods to financing a company: debt and equity finance. Many member States draw a distinction in the direct tax treatment of these two forms of finance. In the case of debt finance, companies are generally permitted to deduct interest payments on loans for the purpose of calculation of their taxable profits (i.e. pre-tax), on the basis that this constitutes current expenditure incurred for the pursuit of the business activities. In the case of equity finance, however, companies are not permitted to deduct distributions paid to shareholders from their pre-tax profits; rather, dividends are paid from taxed earnings.’<sup>982</sup>

This difference in tax treatment gives an incentive to a parent company to finance its subsidiary through an excessive amount of debt rather than funding it with equity capital, which gives a rise to thin capitalisation.<sup>983</sup> ‘The tax incentive to do so is particularly evident if the subsidiary is located in a relatively “high-tax” jurisdiction, while the parent company (or indeed an intermediate group company which provides the loan) is located in a lower-tax jurisdiction’.<sup>984</sup> In such circumstances, what is in substance an equity investment may be presented in the form of a debt in order to obtain a more favourable tax treatment<sup>985</sup> and consequently the interest profit is shifted to the

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<sup>980</sup> See Council Resolution of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalisation rules within the EU, OJ C 156, 16.6.2010, pp. 1–2.

<sup>981</sup> Otmar Thoemmes, and Katja Nakhai, ‘Thin Capitalization Rules and Non-Discrimination Principles: An analysis of Thin Capitalization Rules in Light of the Non-discrimination Principle in the EC Treaty, Double Tax Treaties and Friendship Treaties’, *Intertax*, Vol. 32, No. 3, 2004, pp.126-137 at 137.

<sup>982</sup> Advocate General Geelhoed opinion (2006) in Case C-524/04, *Thin Cap GLO v Commissioners of Inland Revenue* [2007] ECR I-02107, para.3.

<sup>983</sup> Nikolaj Vinther and Eric Werlauff, ‘The Need for Fresh Thinking about Tax Rules on Thin Capitalisation’ (2003) *EC Tax Review*, pp.97-106, at 106.

<sup>984</sup> Advocate General Geelhoed opinion (2006) in Case C-524/04, *Thin Cap GLO v Commissioners of Inland Revenue* [2007] ECR I-02107, para.4.

<sup>985</sup> *Ibid.*

country that imposes lower taxation.<sup>986</sup> Therefore, the thin capitalisation issue arises where a company has a high amount of debt capital in relation to equity capital.<sup>987</sup>

The *effect* of the thin capitalisation rules is to limit a company's debt-to-equity ratio so as to combat exceedingly leveraged financing structures. Interest deduction legislation fulfils the same objective but by direct limitation of the tax-deductible interest expenses that a company can recognise.<sup>988</sup> Therefore, the terms 'disallowance interest deduction' and 'thin capitalisation rules' are used synonymously in this research.<sup>989</sup> In most of the EU Member States, for tax purposes the effect of the thin capitalisation rules is the non-deductibility of interest paid on an excessive loan, while in some other Member States the interest is re-characterized as dividends, for tax purposes.<sup>990</sup>

As regards the *approaches* used for determining the existence of thin capitalisation (the excess amount of debt), two common methods are internationally recognised. The first one is the debt /equity ratio: under this approach the effect of thin capitalisation legislation emerges when a company's equity is exceeded by a certain proportion of its debt.<sup>991</sup> From the EU perspective, this test is applicable in all Member States that do apply thin capitalization, except for the UK. This approach seems theoretically unambiguous, but in practice it functions in a complex way, and it contradicts EU law, especially the provisions on the freedom of establishment.<sup>992</sup> Moreover, it is submitted that under this approach the individual circumstances of the taxpayers are not

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<sup>986</sup> Stuart Webber, 'Thin Capitalization and Interest Deduction rules: A Worldwide Survey', Tax Notes International, November 29, 2010, p.683.

<sup>987</sup> Jonathan Farrar & Amin Mawani, 'Debt-Equity Limitations in Thin Capitalization Rules: Canadian Evidence', Annual Conference Paper, p.3, available at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1080639](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1080639)> accessed 20 November 2012; International Bureau for Fiscal Documentation, 'International Tax Glossary', 4th Edition, IBFD (2005), p.357; OECD, Thin Capitalisation (1986), Para. 12; OECD Report on "Thin Capitalisation" Adopted by the OECD Committee on Fiscal Affairs, 1986.

<sup>988</sup> Stuart Webber, 'Thin Capitalization and Interest Deduction Rules: A Worldwide Survey', Tax Notes International, November 2010, p.683.

<sup>989</sup> Interest stripping or earning stripping' term is used by some scholars as a reference to the outcome of thin capitalisation of which the income is shifted from one jurisdiction to another, see Joseph Isenbergh, *International taxation*, (New York: Foundation Press, 2005), p.33.

<sup>990</sup> Ana Paula Dourado, Rita de la Feria, Thin Capitalisation and Outbound Investment' in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base*, (Linde, 2008), p.792.

<sup>991</sup> This method are applicable in the US, Japan, Canada and New Zealand see Stuart Webber, 'Thin Capitalization and Interest Deduction rules: A Worldwide Survey', Tax Notes International, November 2010, p.683.

<sup>992</sup> ECJ C-524/04, *Thin Cap GLO*, [2007] ECR I-02107, Para. 80.

considered and consequently it does not reflect the flexibility of the thin capitalisation rules as required by the OECD.<sup>993</sup>

The second approach is the *arm's length principle*: under this approach, thin capitalisation is detected by comparing the actual financing structure with that which would have been carried out between independent parties. The taxpayer has to prove that the same debt could have been borrowed from a third party under the same conditions. What would be regarded as proof depends on the relevant case, but there are some common criteria that can be used, such as the relation between the lender and the borrower, the interest rate, and a comparison with the fixed debt/equity ratio.<sup>994</sup>

One of the ECJ's rulings has implied a preference for adoption of the arm's length approach in the thin capitalization rules.<sup>995</sup> In this ruling the ECJ stated that the *effect* of the national thin capitalisation rules in the Member States is justified only "if, and in so far as, *it exceeds what those companies would have agreed upon on an arm's-length basis*", meaning that thin capitalization rules should be based on the arm's length approach.<sup>996</sup> In addition, it is submitted that the so-called "flexible thin capitalisation rules" of the OECD indicate a preference for the arm's length principle.<sup>997</sup>

However, thin capitalisation rules under the arm's length approach would raise several issues, ranging from significant compliance costs to opportunities for tax planning.<sup>998</sup> The application of the arm's length principle alone to tackle thin capitalisation issues is in fact problematic. A substantial aspect of such problems is the objective nature of the arm's length principle, which may present legal uncertainty<sup>999</sup> and place a significant administrative burden on both taxpayers and tax administration.<sup>1000</sup> This was clearly

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<sup>993</sup> Andrew M. C. Smith and Paul V. Dunmore, 'New Zealand's Thin Capitalization Rules and the Arm's Length Principle' Bulletin for International Taxation, Vol. 10, 2003, pp.503-510, at.505.

<sup>994</sup> Linda Brosens, 'Thin Capitalisation Rules and the EU law' EC Tax Review, Vol. 13, No.4, 2004, pp. 188-213, at 190.

<sup>995</sup> ECJ C-524/04, *Thin Cap GLO*, [2007] ECR I-02107, Para. 80.

<sup>996</sup> *Ibid.*

<sup>997</sup> Andrew M. C. Smith and Paul V. Dunmore, 'New Zealand's Thin Capitalization Rules and the Arm's Length Principle' Bulletin for International Taxation, Vol. 10, 2003, pp.503-510, at.507.

<sup>998</sup> Ben Terra and Wattel, *European Tax Law*, (Kluwer Law International 2008), p.577.

<sup>999</sup> OECD Report on "Thin Capitalisation", the OECD Committee on Fiscal Affairs, 1986, Para. 25.

<sup>1000</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, 2010, p.159.

evident when a similar approach to this was adopted by the United Kingdom in 2004.<sup>1001</sup>

As regards the *scope* of thin capitalisation rules, it varies significantly among the Member States of the EU; some Member States apply the thin capitalisation rules to related parties, and in this respect the required ownership threshold differs widely among these states. In some other Member States there is no ownership requirement, i.e. they provide a general fixed ratio rule for all transactions.<sup>1002</sup> In other words, thin capitalisation rules apply only to loans from associated parties in some Member States, whereas in other member States these rules are applicable to loans from both associated and non-associated parties.

Against the definition of thin capitalisation, and the structure and justification of the thin capitalisation rules, the question arises as to whether this kind of tax planning would emerge in the context of the CCCTB and consequently thin capitalisation legislation will be required.

#### **4.4.2.2.1 Jurisdictional scope of thin capitalisation rules**

In principle, within the water's edge of the CCCTB, it is likely that thin capitalisation would not be an issue within the members of the consolidated group, as intra-group transactions are in principle eliminated.<sup>1003</sup> That is to say, loans would be consolidated and interest deduction and receipts are grossed up, thereby the consolidated tax base is not affected.

##### **4.4.2.2.1.1 Thin capitalisation rules in relations between CCCTB and non-CCCTB Member States**

The implementation of thin capitalisation rules within the EU is, in principle, allowed in order to ensure that the terms of the debt financing between related parties would be similar to what would have been agreed upon between independent parties. However, it

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<sup>1001</sup> Ana Paula Dourado and Rita de Faria, 'Thin Capitalisation and Outbound Investment', in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.), *Common Consolidated Corporate Tax Base* (Linde, 2008), p.819.

<sup>1002</sup> *Ibid.*

<sup>1003</sup> Art. 59 of the CCCTB Directive.

is still subject to some restrictions resulting from the ECJ ruling, which confined the scope of the thin capitalization rule to the objective of detecting ‘in whole or in part, a purely artificial arrangement’.<sup>1004</sup> This was also reiterated by the European Commission, which states that the prevention of thin capitalisation itself is allowed, but it must be confined to purely artificial arrangements.<sup>1005</sup> Therefore, if the anti-abuse rules are applicable between the CCCTB Member states and other EU countries they will be subject to the restrictions laid down by the ECJ.

#### **4.4.2.2.1.2 Thin capitalisation rules in relation to third countries**

As regards the application of thin capitalisation rules towards third countries, contrary to the ECJ’s ruling that such rules within the EU target only wholly artificial arrangements,<sup>1006</sup> they are applicable to third countries without restriction. As these rules normally apply to the situation where a foreign company holds a *substantial amount* of debt in a resident subsidiary, their application touches upon the freedom of establishment.<sup>1007</sup> However, as mentioned earlier, in accordance with the ECJ judgment, the application of thin capitalisation rules towards third countries does not infringe the freedom of establishment because EU law does not require the Member States to avoid discrimination in relation to third countries. Hence, applying thin capitalisation rules to third countries is legitimate.

#### **4.4.2.2.2 Are thin capitalisation rules required in relation to third countries in the CCCTB context?**

According to the CCCTB Directive, the two methods of corporate finance, i.e. debt and equity, are treated differently. For the purpose of calculating the tax base, the deductible expenses include financial costs [...] costs ‘incurred in raising equity or debt for the purpose of the businesses’.<sup>1008</sup> Therefore, interest paid by a CCCTB group member to an associated enterprise in a *third country* is basically tax deductible from the tax base of that group member. The interest deduction at the individual tax base level is in fact

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<sup>1004</sup> ECJ Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2017, Paras, 81 and 82.

<sup>1005</sup> European Commission, ‘The Application of Anti-abuse Measures in the Area of Direct Taxation – within the EU and in relation to Third Countries’ (Communication) COM(2007) 785 final, p.7.

<sup>1006</sup> ECJ C-524/04, *Thin Cap GLO* [2007] ECR I-02107, Para. 82.

<sup>1007</sup> Christiana HJI Panayi, ‘The Fundamental Freedoms and Third Countries: Recent Perspective’, *European Taxation*, November 2008, pp.571-582, at 574

<sup>1008</sup> Art. 12 of the CCCTB Directive; European Commission, ‘Possible Elements of a Technical Outline’, (CCCTB/WP057/doc/en), Para.24.

interest deductible from the consolidated tax base of the group (the consolidated tax base is affected) because the individual tax bases of a group's members are consolidated and apportioned according to the formula apportionment.<sup>1009</sup> In contrast, profit distributions as dividends are treated as non-deductible.<sup>1010</sup> Therefore, this distinction between debt and equity financing modes raises the issue of thin capitalisation in the CCCTB.

The thin capitalisation issue arises where, for instance, a loan is made by a company resident in a third country to its consolidated permanent establishment in the EU, and the interest paid by the permanent establishment is deductible from its tax base. Knowing that by virtue of consolidation, i.e. the individual tax bases are pooled together, deducting interest from an individual tax base is in fact interest deductible from the consolidated tax base.<sup>1011</sup> Such deductibility, therefore, would reduce the consolidated tax of the group in favour of the third country of the lending company.<sup>1012</sup> In this context, the consolidated tax base might be vulnerable to abusive practices where third-country-related entities finance their consolidated entity through a substantial amount of debt, meaning that funding the consolidated group by related entities (not consolidated) in a third country gives rise to thin capitalisation.<sup>1013</sup>

Since the transactions between the consolidated group's members and related companies in third countries would be in principle subject to the arm's length principle,<sup>1014</sup> namely in respect to loan transactions, both the amount of interest and the amount of loan are subject to the arm's length price.<sup>1015</sup> It follows that if the interest payment is priced at arm's length it would not raise the objection of the Member State of the borrowing entity, or the tax authorities of the Member States in which the other group members are resident. However, an excessive amount of interest payment to *low-taxed* third countries would be objectionable both to the Member State tax authority of

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<sup>1009</sup> See 2.4.2 in Chapter 2.

<sup>1010</sup> Art. 14(g) of the CCCTB Directive.

<sup>1011</sup> Art. 57 of the CCCTB Directive.

<sup>1012</sup> Malcolm Gammie and Christiana HJI Panayi, 'Inbound Investment and Thin Capitalization' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p. 840.

<sup>1013</sup> European Commission, 'Anti abuse Rules', (CCCTB/WP065/doc/en), p.3.

<sup>1014</sup> Art. 79 of the CCCTB Directive (it is critical that the CCCTB Directive provides for a common basis for making transfer pricing adjustment).

<sup>1015</sup> European Commission, 'Possible Elements of a Technical Outline', (CCCTB/WP057/doc/en), p.44.

the borrowing company and to the other tax authorities which are entitled to share the consolidated tax base, because they might be directly affected by the reduction of their share from the consolidated tax base.<sup>1016</sup> In this case, the thin capitalisation rules will be required in conjunction with transfer pricing rules.

Additionally, as outlined above, Member States apply very different approaches to thin capitalisation rules; not having a common approach on thin capitalisation would facilitate tax planning. Thin capitalisation rules could be escaped, however, if a company in a third country first grants a loan to a subsidiary resident in a Member State without thin capitalisation rules, and afterwards this loan is directed to the relevant company via intra-group transactions. Owing to the consolidation process (i.e. intra-group transactions are grossed up and hence are not taxed), such tax planning of thin capitalisation will be facilitated.<sup>1017</sup>

Furthermore, a common approach to thin capitalisation rules should be laid down for a fair play issue.<sup>1018</sup> This means that a Member State which individually operates an approach of unlimited deduction of items (these items may be considered as non-deductible in other Member States) would be still apportioned an unreduced share of the consolidated tax base. In contrast, a Member State which restricts such deductions would receive a reduced share of the consolidated base, due to the unilaterally unlimited permitted deductions by the former Member State.<sup>1019</sup> Therefore, it seems that the introduction of a common disallowance of interest deduction is justified in the context of the CCCTB, in particular in relation to third countries. Accordingly, the CCCTB Directive adopted a common approach of thin capitalization rules in relation to third countries instead of the variation of such rules in the individual Member States of the EU.<sup>1020</sup>

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<sup>1016</sup> Malcolm Gammie and Christiana HJI Panayi, 'Inbound Investment and Thin Capitalization' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p. 840.

<sup>1017</sup> Christoph Spengel, Carsten Wendt, 'A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues and Options' (2007) Oxford University Centre for Business Taxation Working Papers, pp.41,42.

<sup>1018</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.82.

<sup>1019</sup> European Commission, 'International Aspects in the CCCTB', (CCCTB\WP\019\doc\en), para.38.

<sup>1020</sup> *Ibid*, para.39.



In order to assess the sufficiency of these rules in relation to third countries, the provisions in the CCCTB Directive will be analysed in depth in the next section.

#### **4.4.2.3 The features of the disallowance of interest deduction rule in the CCCTB and the scope of thin capitalisation rules**

The thin capitalisation rule is only applicable to an associated enterprise resident in third countries. In this respect, the common definition of the associated enterprise as provided in the CCCTB system is relevant.<sup>1021</sup> Furthermore, it goes without saying that the thin capitalisation rule functions in the situation of *inbound investment*, i.e. outgoing payments in the form of interest payable to an associated enterprise in a third country. Moreover, for the purposes of applying the thin capitalisation rule, the CCCTB Directive defines ‘interest’.<sup>1022</sup> Notably, it strictly follows the wording of the definition in the OECD Model.<sup>1023</sup>

The CCCTB Directive stipulates two conditions for thin capitalisation rules to operate in relation to third countries: firstly, the interest paid to a third-country associated enterprise is not deductible either where the statutory corporate tax rate under the general tax regime in the third country is lower than 40% of the average statutory corporate tax rate applicable in the Member State, or *alternatively* where there is a special regime in the third country that allows for a substantially lower level of taxation than that of the general regime.<sup>1024</sup> In defining *low taxation* and *special regime* in third countries, what has been analysed above in connection with the switch-over clause would be relevant here. Similarly, as in the case of the switch-over clause, the average corporate tax rate that Member States apply will be published yearly by the European Commission.

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<sup>1021</sup> Art. 78 of the CCCTB Directive.

<sup>1022</sup> Interest is defined in Art. 81(1) of the CCCTB Directive as follows:

‘the income from debt-claim of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from securities and income from bonds or debentures, including premium and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest’

<sup>1023</sup> Art 11(3) of the OECD Model Tax Convention.

<sup>1024</sup> Art. 81(1) of the CCCTB Directive.

Furthermore, the Directive requires an absence of agreement exchange comparable to the standard of the recent Mutual Assistance Directive<sup>1025</sup> 2011/16/EU.<sup>1026</sup> According to the ECJ's interpretation of Art.63 (1) of the TFEU on the free movement of capital between Member States and third countries, this freedom is contingent on the existence of an exchange of information between the Member State and the third country involved.<sup>1027</sup> As mentioned earlier, the application of thin capitalisation rules falls under freedom of establishment (definitive influence and control). However, this condition is intended to cover other cases where the application of thin capitalisation rules falls within the ambit of the free movement of capital. Therefore, in such cases, this condition aligns the thin capitalisation rules with EU law and judicial precedent.<sup>1028</sup> Where there is no an agreement on exchange of information between a CCCTB-Member State and a third country, in all cases the application of thin capitalisation rules would not violate the free movement of capital in relation to third countries.

#### **4.4.2.2.3.1 Methods of determining thin capitalisation practice**

Notably, the CCCTB Directive refers to neither the 'debt/equity fixed ratio' test nor to the arm's length principle as a method for determining the existence of thin capitalisation. Instead, it merely applies thin capitalisation in situations involving an associated enterprise resident in a third country, which operates a *special tax regime* or adopts a *low taxation system*, and which does not engage in an exchange of information mechanism. Having said that transfer pricing under the arm's length principle will generally still apply between CCCTB companies and their associated enterprises in third countries, not stipulating the arm's length test for the thin capitalisation rules implies that such rules are drafted as an *irrefutable presumption*. This means that where the above conditions are met, thin capitalisation is considered to exist without the need for any further tests. This makes the scope of these rules very wide and also implies that the very focus of thin capitalisation rules is on combating income-shifting to third countries.

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<sup>1025</sup> Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation[2011] OJ L 64/1 and repealing Council Directive (EEC)77/799 of 19 December on mutual assistance by the component authorities of the Member States on the field of direct taxation[1977] OJ L336.

<sup>1026</sup> Art. 81(1) of the CCCTB Directive.

<sup>1027</sup> ECJ Case C-201/05 *CFC GLO* [2008] ECR I-02875, Paras. 95-96.

<sup>1028</sup> European Commission, 'Anti-Abuse Rules in the CCCTB', (30 August 2010, CCCTB/RD\004\doc\en), Para.12.

Although the arm's length method has been suggested for thin capitalization including both interest and the amount of debts,<sup>1029</sup> the position taken by the CCCTB Directive is welcome, because in the context of CCCTB, the application of the arm's length principle is expected to result in the same problems as mentioned above and even more.<sup>1030</sup> This is not desirable, as one of the CCCTB's purposes is to eliminate transfer pricing complexities in the EU.<sup>1031</sup> In the light of this, an appropriate solution, in order to deal with these complexities, is to avoid the adoption of the arm's length approach in thin capitalization rules in the CCCTB. However, the method adopted by the CCCTB Directive would contradict the arm's length test upon which the tax treaties with third countries are most likely to be based.

Eventually, the *effect* of thin capitalisation rules in the CCCTB is the denial of deductions for interest paid to associated enterprises resident in third countries.<sup>1032</sup> This would make such payments indirectly taxable within the consolidation jurisdiction. Apparently, this effect is very severe because the thin capitalisation is assumed where the above conditions are satisfied, i.e. where 'the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions'.<sup>1033</sup> Normally, 'the corrective tax measure should be limited to the part which *exceeds* what would have been agreed if the companies did not have a relationship of interdependence'.<sup>1034</sup> However, the CCCTB Directive disallows the entire interest deduction, not just the excessive part. This seems to reveal the punitive nature of the CCCTB's thin capitalisation rules, which would make such rules effective to combat income shifting to a third country. In any case, there is an escape clause to this effect.

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<sup>1029</sup> European Commission, Summary Record of the meeting of Common Consolidated Corporate Tax Base, (CCCTB/WP/059/draft/en), p.9; European Commission, 'Related Parties in the CCCTB', (CCCTB/WP/041/doc/en), pp.7-8.

<sup>1030</sup> Malcolm Gammie and Christiana HJI Panayi, 'Inbound Investment and Thin Capitalization' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base*, (Linde 2008), p.820.

<sup>1031</sup> European Commission, 'Company Taxation in the Internal Market', COM(2001)582 final,p.10

<sup>1032</sup> Art. 81(1) of the CCCTB Directive.

<sup>1033</sup> ECJ C-311/08, *SGI v État belge*, [2010] ECR I-00487, Para. 72.

<sup>1034</sup> *Ibid*; this is also evident in the current thin capitalisation rules in the Member States of the EU, see Ana Paula Dourado and Rita de Faria, 'Thin Capitalisation and Outbound Investment', in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), pp.788-800.

Furthermore, the CCCTB Directive does not determine who is entitled to uphold the *effect* of thin capitalisation rules, i.e. denying the interest deduction. This issue is critical in relation to third countries with respect to tax treaty relevance. It seems that there are two possibilities on the horizon: either the Member State of the borrower entity or the principal taxpayer would be responsible<sup>1035</sup> even if the latter is resident in another Member State where the consolidated tax base would be audited. The interest deduction should be denied by the principal taxpayer, as this would be simple and coherent as the disallowance interest deduction rule would be implemented at the consolidated group level. This solution also appears to be an adequate solution, in particular when the amount of deductible interest is to be done on a consolidated basis.<sup>1036</sup> However, thin capitalisation arrangements in the tax treaty between the CCCTB-Member State and third country concerned would be overridden.<sup>1037</sup>

On the other hand, if the Member State of the borrowing company has the right to deny interest deduction, this would not contradict the existing tax treaties with a third country, although there could be opportunities for tax planning for lenders from third countries. For instance, loans could be routed to the final debtor via other consolidated companies in CCCTB countries with a flexible attitude to thin capitalisation practices.<sup>1038</sup> However, as long as the Member States apply a common approach to thin capitalisation rules, this tax planning opportunity would not occur. Therefore, the second approach can be adopted, i.e. the denial right should be given to the Member State of the borrowing company.

#### **4.4.2.2.4 Escape clause in the thin capitulation rules**

The disallowance of interest deduction contains an *escape clause*: interest paid to a company resident in a third country will still be deductible *in an amount not exceeding that which would be stipulated between independent enterprises* – the arm’s length principle – where one of the three cases of escape clauses is satisfied:<sup>1039</sup> firstly, if the interest is included in the tax base of the taxpayer as a CFC income; secondly, where the

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<sup>1035</sup> For the definition of principal taxpayer see Art. 4(8) of the CCCTB Directive.

<sup>1036</sup> For more details see European Commission, ‘Possible Elements of the Administrative Framework, (13 November 2007, CCCTB/WP061\doc\en), p.7 et seq.

<sup>1037</sup> Christiana HJI Panayi, ‘The Common Consolidated Corporate Tax Base and the UK Tax System’ (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.86.

<sup>1038</sup> *Ibid*, p.86.

<sup>1039</sup> Art 81(3) of the CCCTB Directive.

interest is paid to a company whose principal class of shares is regularly traded on one or more recognised stock exchanges.<sup>1040</sup> It is submitted that this second condition is designed to ensure that the associated enterprise income is already taxed; hence the interest deduction will be allowed. This means that the interest paid to a third low-tax country would not be objectionable to the CCCTB group member, as it does not constitute tax avoidance or income shifting to the third country's jurisdiction.<sup>1041</sup> Thirdly, the interest paid to an entity resident in a third country will continue to be deductible at arm's length if such entity is engaged in the active conduct of trade or business. This would indicate that such entity in the third country is economically independent.<sup>1042</sup>

The escape clause in this regard would mean that where there is a suspicion of thin capitalisation practice, the taxpayer has to be given an opportunity to provide evidence of any commercial justification; when it is proven that an abusive practice does not exist, the interest deduction will be allowed. It can be noticed that none of these three cases provides for the escape clause test; namely, no reference has been made to the arm's length test. The third escape clause, however, states that where the company in the third country to which the interest is paid is engaged in the active conduct of trade or business, this indicates that such company is an *independent* economic enterprise, especially where substantial managerial and operational activities are carried out by its employee and officers. However, this test is considered to be different from the arm's length test.<sup>1043</sup>

The test which is incorporated in the third the escape clause is similar to a '*business purpose test*'. Under such test, any tax deductible expense is 'required to be incurred strictly in the company's business in production, maintenance or securing income'.<sup>1044</sup> While the latter test is subjective, the arm's length test is an objective one. However, since the effect of the escape clause application is the interest deduction at arm's length

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<sup>1040</sup> Art 81(3) of the CCCTB Directive.

<sup>1041</sup> European Commission, 'Anti-Abuse Rules in the CCCTB, 930 August 2010, CCCTB/RD\004\doc\en), p.5.

<sup>1042</sup> Art. 81(3) of the CCCTB Directive

<sup>1043</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.86.

<sup>1044</sup> European Commission, 'Related Parties in the CCCTB', (5 December 2006, CCCTB\WP\041\doc\en), Para.26.

and only where one of the three cases is met, it can be said that the escape clause observes the application of arm's length. Nevertheless, in implementing these escape clauses in relation to third countries, they are likely to conflict with underlying third country tax treaties which are most probably based on the arm's length test but without certain conditions. Therefore, these different tests would necessitate reconsidering the existing tax treaties with third countries.

Moreover, the escape clause is applicable though there is no agreement on the exchange of information between Member States and third countries. However, the Directive does not indicate how a taxpayer should prove that these escape clause situations exist, particularly in the absence of such mechanism for information exchange.<sup>1045</sup>

#### **4.4.3 The relationship between the CCCTB's GAAR and specific anti-abuse rules**

The stance taken by the CCCTB Directive in respect to the concept of GAAR is generally puzzling,<sup>1046</sup> in respect to the latter's scope and objective and its overlap with other anti-abuse rules.<sup>1047</sup> There is no explicit statement of the hierarchy between the GAAR and other specific anti-abuse rules. In other words, the Directive lays down the GAAR, but it does not clarify whether this rule applies only within the EU or in relation to third countries. Neither is it clear whether the GAAR only applies to situations outside the scope of the specific anti-abuse rules, or whether it operates in conjunction with the latter type of rules, so that a transaction that is not caught by one of the specific rules could still be tackled by the GAAR.

Presumably, the GAAR can be applied within the EU and towards third countries, because the specific anti-abuse rules analysed above are limited to the relations with third countries, as clearly stated by the CCCTB Directive. What is more, the ECJ restricts the application of the specific anti-abuse rules to only 'wholly artificial arrangements' on the ground that they are not compatible with the EU Member States' Treaty obligations. Knowing that curbing the 'purely artificial arrangements' is the

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<sup>1045</sup> KMPG Guide to CCCTB part II, p.68.

<sup>1046</sup> See the preamble of the CCCTB Directive, para. 20.

<sup>1047</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.72.

main purpose of the GAAR, the implication is that it is to be applied in the EU and towards third countries, and the specific anti-abuse rules are to be applied in relation to third countries only. In other words, giving the GAAR provision an objective similar to the aim of the specific anti-abuse rules' as specified by the ECJ, i.e. eliminating the 'purely artificial transactions', can imply that the GAAR legislation can be considered as an alternative for the specific anti-abuse rules in respect to transactions between the CCCTB Member States and other EU countries. However, drafting specific anti-abuse rules narrowly renders them easily avoidable, which would lessen their protectively objective.<sup>1048</sup> It seems that the CCCTB Directive has taken this position either because it did not expect any abstainers from the CCCTB project, or in order to encourage Member States in the EU to curb or at least remodel their anti-abuse legislation, especially specific anti abuse rules within intra-Community situations.

However, the CCCTB Directive does not explicitly state that the Member States shall refrain from operating specific anti-abuse rules within the EU where the GAAR is applicable. This gives the Member States the latitude to use different anti-abuse measures, especially GAAR which is more vague and general.<sup>1049</sup> Leaving this area to domestic legislation, especially when there is no coordination between Member States, would introduce the risk of inconsistent provisions and unnecessary complication in the CCCTB. Therefore, it may be worth considering the possibility of providing a common approach in order to avoid uncertainty.<sup>1050</sup> It is suggested that the European Commission could fill this legislative gap in the CCCTB Directive. If the GAAR is applicable in the EU instead of specific anti-abuse rules, however, the Member States will be given the flexibility to combat the abusive practice. Nonetheless, there would be an application difficulty, as the GAAR provision would be interpreted differently at the Member States level, and therefore could create uncertainty,<sup>1051</sup> not to mention the fact

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<sup>1048</sup> Zoë Prebble and John Prebble, 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law', *Bulletin for International Taxation*, April 2008, pp. 151-170, at 154.

<sup>1049</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) *The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9*, p.72.

<sup>1050</sup> European Commission, *International Aspects in the CCCTB*, (18/11/2005, CCCTB\WP\019\doc\en.),p.15.

<sup>1051</sup> European Commission, 'Anti Abuse Rules', (26 March 2008, CCCTB\WP065\doc\en), p.3.

that most of Member States do not apply GAAR.<sup>1052</sup> In contrast, the specific anti-abuse provisions would have the benefit of introducing a higher level of certainty as well as being simpler to administer.<sup>1053</sup>

Moreover, it is submitted that the combination of the GAAR and specific anti-abuse rules in respect to transactions between CCCTB-Member States and non-CCCTB Members should prevail as it is advantageous from an administrative point of view. In other words, the well-known cases of abuse will certainly be targeted by specific anti-abuse rules, while the unexpected cases and those uncovered by the latter will be prevented by the GAAR.<sup>1054</sup>

#### **4.5 Conclusion**

This chapter examined the CCCTB's framework for the avoidance of double taxation and for the protection of the common consolidated tax base. It showed that elimination of international double taxation in respect to cross-border activities in third countries is critical for the optimal function of the Internal Market with the economies of third countries. The chapter also showed that exemption with the progression approach, which is associated with the switch-over clause, and ordinary credit method (both of which that are provided in the CCCTB Directive) is effective for eliminating international double taxation and double non-taxation. Furthermore, these methods are in line with the CIN policy and territoriality principle. This chapter established that the GAAR is applicable to intra-community transactions and in relation to third countries, but specific anti-abuse rules apply only in relation to third countries. The CCCTB measures, such as switch-over clause, CFC rules and thin capitalisation rules would sufficiently protect the common consolidated tax base against tax erosion and evasion. However, these measures are likely to contradict the current tax treaties concluded between the CCCTB Member States and third countries. This issue will be examined in the next chapter.

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<sup>1052</sup> Ana Paula Dourado, Rita de la Feria, 'Thin Capitalisation and Outbound investment', in Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p.807.

<sup>1053</sup> *Ibid.*

<sup>1054</sup> European Commission, 'Anti abuse rules' (26 March 2008, CCCTB/WP065\doc\en), p.3.



## **5 Compatibility of the CCCTB Rules with Double Tax Treaties Concluded between Third Countries and Member States**

### **5.1 Introduction**

Based on customary international tax law, a common tax jurisdiction of the CCCTB Member States is defined in the CCCTB Directive, i.e. worldwide taxation of residents and source taxation of non-residents.<sup>1055</sup> The CCCTB Directive unilaterally provides common rules for the elimination of double taxation, which would inevitably result from the overlapping of the CCCTB tax jurisdiction and the third countries' tax jurisdiction. In the previous chapter, it was established that these rules would effectively prevent double taxation. However, these rules may contradict the existing tax treaties between the CCCTB Member States and third countries, which were concluded before the introduction of the CCCTB system to the EU.

Furthermore, for the purposes of protection of the common tax base, the CCCTB Directive contained certain common anti-abuse provisions, applicable in relation to third countries, such as switch-over clauses, CFC rules and thin capitalisation rules. Arguably, these provisions are sufficient for protecting the common tax base, but they are likely to be in breach of the current tax treaties signed between the CCCTB Member States and third countries. Incompatibility with third-country double tax treaties may also arise in respect to transfer pricing rules provided in the CCCTB Directive.

To this end, this chapter examines the compatibility of the CCCTB rules, which apply in an international context, with existing OECD-based tax treaties concluded between CCCTB-Member States and third countries. It argues that incompatibility between the CCCTB rules and such tax treaties is likely to arise, thus optimal solutions to eliminate such incompatibility will be suggested from both a short and long-term perspective. Some provisions may need to be changed, or even become obsolete by virtue of the CCCTB system; moreover some cases of non-treaty situations may be found. The basis for the compatibility test will be the OECD Model, as most of the EU-Member States

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<sup>1055</sup> Sjoerd Douma, 'The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation', *European Taxation*, November 2006, pp.522-533, at 523.

usually follow the OECD Model in their tax treaties with third countries. In effect, this implies that the treaty between a CCCTB-Member State and third country often contains the same provisions as those of the OECD. However, it is beyond the scope of this chapter to examine the compatibility of the CCCTB rules with third-country tax treaties, which contain different provisions to those of the OECD Model.

## **5.2 Structure of tax treaties, the OECD Model and its commentary**

Since the compatibility test is based on the OECD Model, it is necessary to outline here the structure of the tax treaties and OECD Model and the role of OECD commentary in the interpretation of tax treaties before we explore the specific compatibility issues of the CCCTB rules with third-country tax treaties.

Tax treaties are international agreements between countries, and most of them are bilateral; however, there are a considerable number of regional multilateral tax treaties, and they constitute an important part of international tax law.<sup>1056</sup> The accelerating integration of domestic economies and the increase in the number of enterprises that operate worldwide have significantly raised the importance of tax treaties, particularly over the last six decades.<sup>1057</sup> The main purpose of tax treaties is to promote international investment and trade by diminishing the obstacle of double taxation to cross-border businesses. Tax treaties eliminate international double taxation, which may be either a juridical double taxation or an economic one. International juridical double taxation occurs where the same taxpayer is subject to similar taxes on the same item of income or capital gains for the same income period, but in two different countries or more.<sup>1058</sup> In contrast, international economic double taxation arises where the same item of income is taxed in the hands of two different taxpayers in two countries.<sup>1059</sup>

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<sup>1056</sup> Michael Kobetsky, *International Taxation of Permanent Establishment* (Cambridge University Press 2011), p.155.

<sup>1057</sup> *Ibid.*

<sup>1058</sup> Commentary to Art. 23 A and B OECD 2010, para. 3; Vogel Klaus, *Klaus Vogel on Double Tax Conventions*, p.10.

<sup>1059</sup> Commentary to Art. 10, OECD Model, 2010, para. 41.

Double taxation results from the overlapping of two countries' tax jurisdiction.<sup>1060</sup> Tax treaties tackle this problem by allocating tax rights over items of income or over taxpayers between the contracting states. This means that the contracting states mutually bind themselves not to levy taxes, or to impose taxes only to a limited extent; and in some cases the treaty reserves the taxing right for the other contracting state either entirely or partially.<sup>1061</sup> However, tax treaties do not create a jurisdiction to tax; tax treaties neither set up additional rules nor choose between applicable domestic and foreign law.<sup>1062</sup> The concept in tax treaty law is that each state applies its domestic tax law; nevertheless restrictions are imposed by the relevant tax treaty.<sup>1063</sup> It is also critical to stress that a tax treaty could only limit tax claims made by a state but it never extends the tax legislation scope of a state.

Moreover, tax treaties are used as an important means of combatting international tax avoidance.<sup>1064</sup> The traditional main objective of a bilateral double tax agreement is the elimination of double taxation, and recently, the target has been to combat international tax avoidance. Furthermore, tax agreements are used to prevent fiscal discrimination, and also as a mean for exchanges of information between the contracting states, so the provisions on exchange of information can be used to eliminate international tax avoidance.<sup>1065</sup> Most tax treaties are based on the OECD Model, thus it is critical to outline the main features of such Model.

### 5.2.1 OECD Model tax convention

The OECD Model finds its origin in the work of the League of Nations, which was established in the 1920s to develop some uniformity in agreements used by countries to prevent double taxation and fiscal evasion. The work of the League of Nations was picked up by the Organisation for European Economic Co-operation (OEEC), which

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<sup>1060</sup> Vogel, Klaus, *Klaus Vogel on double tax conventions: A commentary to the OECD- UN, and US Model Conventions for the Avoidance of Double Taxation of Income and Capital with Particular reference to German Treaty Practice* (3<sup>rd</sup> edition, Kluwer Law International, London 1997), p.11.

<sup>1061</sup> Pasquale Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions* (Kluwer Law International 2002), p.87.

<sup>1062</sup> Vogel, Klaus. *Klaus Vogel on Double Tax Conventions*, p.26.

<sup>1063</sup> *Ibid.*

<sup>1064</sup> Stef Van Weeghel, *The Improper Use of Tax Treaties* (Kluwer Law International 1998), pp.34-35.

<sup>1065</sup> Sara Andersson, 'CFC rules and Double Tax Treaties ;the OECD and UN model tax conventions', Jonkoping International business School Jonkoping University , August 2006, p.6

was transformed into the Organisation for Economic Co-operation and Development (OECD) in 1961.<sup>1066</sup> In 1963, the fiscal committee of the OECD submitted a draft with the title of *Draft double tax convention on income and capital*.<sup>1067</sup> The 1963 draft model treaty and the accompanying commentary were revised in 1977 by the fiscal committee to fit with the economic conditions at that time.<sup>1068</sup> In 1991, it was recognised that the OECD Model and its commentary should be periodically updated and amended.<sup>1069</sup> This led to the publication of the 1992 OECD model treaty and commentary in loose-leaf format, thus the updating could be done more frequently in response to on-going development.<sup>1070</sup> Following the publication of the 1992 OECD Model, it was subsequently updated in 1994, 1995, 1997, 2000, 2003, 2005, 2008 and 2010.<sup>1071</sup>

The main objective of the OECD Model is to ‘clarify, standardise and confirm the fiscal situation of taxpayer who are engaged in commercial, industrial, financial or any other activities in other countries through the application, by all countries, of common solutions to identical cases of double taxation’.<sup>1072</sup> The OECD Model seeks to provide common solutions to identical cases of double taxation<sup>1073</sup>, tax avoidance and in some cases double non-taxation.<sup>1074</sup> When the OECD Model was issued, OECD members were invited to use the treaty as a model for their negotiations of new bilateral treaties. Although this Model and its commentary are not binding, it has been followed by the OECD members and non-member states as well.<sup>1075</sup>

The OECD commentaries are of great assistance in the application and interpretation of tax treaties in both OECD members and non-OECD countries, especially in countries that do not have a procedure for obtaining an advance ruling on tax matters from the tax administration. It is intended to give guidance on how the provisions of the OECD

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<sup>1066</sup> Klaus Vogel, ‘Double Tax Treaties and Their Interpretation’, *International Tax and Business Lawyer*, Vol.4, No.1, 1986, p.11,

<sup>1067</sup> OECD, *Draft Double Taxation Convention on Income and Capital*, 1963, available at < [faculty.law.wayne.edu/tad/Documents/Tax\\_treaties/oecd\\_1963.pdf](http://faculty.law.wayne.edu/tad/Documents/Tax_treaties/oecd_1963.pdf)> accessed 10 December 2012.

<sup>1068</sup> OECD, *Model Double Taxation Convention on Income and on Capital* (Paris 1977).

<sup>1069</sup> Introduction to the OECD Model, 2010, Para. 10.

<sup>1070</sup> *Ibid*, para. 11.

<sup>1071</sup> OECD Model 2010.

<sup>1072</sup> Introduction to the OECD Model, 2010, Para. 2.

<sup>1073</sup> *Ibid*, para.3.

<sup>1074</sup> Ana Scapa, ‘Avoidance of Double Non-Taxation under the OECD Model Tax Convention’, *Intertax*, Vol. 33, No. 6/7, 2005, pp.266-285, at 284.

<sup>1075</sup> United Nations, *United Nations Model Tax Convention between Developed and Developing Countries*, 2001, p.61, para.19

Model should be understood.<sup>1076</sup> The OECD Model is used as a basis for other models such as the UN Model Double Taxation Convention between Developed and Developing Countries.<sup>1077</sup>

The OECD Model generally contains seven chapters: following the Introduction to the OECD, Chapter I contains the scope provisions of the OECD Model, which include the personal scope (Art. 1) and tax covered (Art. 2). Chapter II contains the definition provisions of the OECD Model. These include a general definition (Art. 3), a residence definition (Art. 4) and a permanent establishment definition (Art. 5). Chapters III and IV contain the distributive provisions, which deal with the allocation of tax jurisdiction in respect to particular categories of income.

These distributive provisions are structured on the basis of ‘classification and allocation’: income is classified by type or category, and the right to tax a certain type of income is then allocated to one or both of the contracting states. In this respect, the OECD Model uses three main categories of distributive rules. In the first category, the jurisdiction to tax particular types of income is exclusively given to the country of residence. This can be found, for instance, in Art. 12(1) on Royalties, Art. 13(4) on Capital gains, Art.18 on Pensions, and Art. 21 on other income. In the second category of distributive rules, a limited taxing right is entitled to the source country as, for instance, in, Art. 10(2) on dividends and Art. 11(2) on interest. Thirdly, with regard to certain types of income, the taxing right is fully given to the source country, and these types of income include, for example, income from immovable property (Art. 6(1)), and business profit (Art. 7(1)). However, in the event that the taxing right is exclusively given to the source country, the residence country may retain its right to tax the income in question.

Where both contracting states have the jurisdiction to tax certain income, Chapter V contains relief provisions for the elimination of double taxation. The OECD Model provides two methods by which the residence country can prevent any resulting double taxation: the exemption method and the credit method (Arts. 23 A and 23 B).

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<sup>1076</sup> Introduction to the OECD Model, 2010, Para. 10.

<sup>1077</sup> United Nations, *United Nations Model Tax Convention between Developed and Developing Countries*, 2001, p.61, para.19.

In Chapter VI of the OECD Model, there are special provisions on the elimination of other potential obstacles to investments and trade between the contracting states. These provisions include the prohibition of discrimination on the bases of nationality and residency in Art. 24, while Art. 26 prevents fiscal evasion via the exchange of information between the tax authorities of the contracting states. A mutual agreement procedure is stipulated in Art. 25 for the purposes of eliminating double taxation and resolving conflicts of interpretation of the treaty.

Although the elimination of international tax avoidance is not among the main objective of tax treaties, the OECD Model contains a number of anti-avoidance provisions applicable in cross-border situations. For example, transfer pricing provisions, including Art. 9, as well as Arts. 11(6) and 12(4), which confine treaty benefits for interest and royalties to an arm's length amount. Nevertheless, these provisions are outlined in very general language and do not address certain abuse situations.

### 5.2.2 The role of the OECD commentary in interpreting tax treaties

The OECD commentaries are used by many countries as a basis for interpreting tax treaties.<sup>1078</sup> Although the OECD Model itself does not refer to the role of the commentary in interpretation of the Model, tax authorities of the OECD members are obliged to consider the commentary in determining the ordinary meaning of tax treaty provisions<sup>1079</sup> in the sense of Art. 31 (1) of the Vienna Convention, particularly where there is no reservation declared by the affected treaty country.<sup>1080</sup> Accordingly, the OECD commentary is used by Canadian, Australian and US courts<sup>1081</sup> in the interpretation of tax treaties.<sup>1082</sup> But the utility of the Commentary by OECD members

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<sup>1078</sup> Introduction to the OECD Model, 2010, para. 15.

<sup>1079</sup> In some cases the OECD commentary is treated as extrinsic aid for determining the meaning of tax convention provisions, see Hugh J. Ault and David R. Tillinghast, *Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals of The American Law Institute on United States Income Tax Treaties* (American Law Institute 1992), p.38

<sup>1080</sup> Rene Matteotti, 'Interpretation of Tax Treaties and Domestic General Anti-abuse Rules-A Sceptical Look at the 2033 Update to the OECD Commentary', *Intertax*, Vol 33, No. 8/9, 2005, pp.336-350 at 339.

<sup>1081</sup> See *The Taisei Fire and Marine Insurance Co v. Commissioner of Internal Revenue* 104 T.C. 27 [1995] 535 and 548.

<sup>1082</sup> The relevance of the OECD commentary in tax treaties interpretation is controversial, mainly because they are periodically updated, for more on this issue see Michael Kobetsky, *International Taxation of Permanent Establishment* (Cambridge University Press 2011), pp.162-178; Jinyan Li and Daniel Sandler,

is subject to their observation on the Commentary and their reservation on an Article of the OECD Model.<sup>1083</sup> This means that because of the reciprocity concept to which the reservation to OECD commentary is subject,<sup>1084</sup> the courts are not allowed to invoke an interpretation of the OECD commentary where the relevant treaty country disagreed with OECD commentary by expressing their reservations or observation on the interpretation of the OECD commentary.<sup>1085</sup>

Recourse to the OECD commentary as an essential tool for interpreting the provision of an OECD-based tax treaty raises the question of whether amendments to the commentary after the adoption of the tax treaty should be taken into consideration.<sup>1086</sup> According to the Committee of Fiscal Affairs, changes or additions to the OECD commentary apply to tax treaties which were concluded before the changes, and should be taken into account as this commentary is consensually considered by the OECD Member States as a proper interpretation of the existing provisions and their application in certain facts and situations.<sup>1087</sup>

Therefore, in this chapter, assessing the compatibility of the CCCTB rules with existing tax treaties negotiated between CCCTB Member States and third countries will be based on the OECD commentary as an essential means for tax treaty interpretation.

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'The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties', Canadian Tax Journal, Vol. 45, No. 5, 1997, pp.891-958, at 899 et seq.

<sup>1083</sup> Introduction to the OECD Model, 2010, para. 29.

<sup>1084</sup> *Ibid*, para. 31.

<sup>1085</sup> Rene Matteotti, 'Interpretation of Tax Treaties and Domestic General Anti-abuse Rules-A Sceptical Look at the 2003 Update to the OECD Commentary', Intertax, Vol 33, issue 8/9, 2005, pp.336-350 at339.

<sup>1086</sup> Some scholars are of the opinion that amendments made to the OECD commentary after the conclusion of certain tax treaties based on OECD Model may only play a limited role in the interpretation of the previously concluded double taxation, see Michael Lang and Florian Brugger, 'The role of the OECD Commentary in Tax Treaty Interpretation', 23 Australian Tax Forum (2008), p.107, available at <langbrugger\_australiantaxforum\_95ff.pdf> accessed 20 October 2012.

<sup>1087</sup> Introduction to the OECD, 2010, para. 35.

### **5.3 Issues raising compatibility of the CCCTB system with OECD Model provisions**

The compatibility of the CCCTB rules with the OECD Model will be examined in respect to three important issues: transfer pricing rules, elimination of double taxation, and anti-abuse rules. Transfer pricing under the arm's length principle is drafted in Article 79 of the proposed CCCTB Directive, and the compatibility of this article with Article 9 in the OECD Model merits examination. As regards income derived by residents in a CCCTB-Member State from third countries (inbound payments), a double taxation relief by exemption and credit is outlined in Articles 11 and 76 of the CCCTB Directive respectively. These articles may be in breach of Arts. 23 A, 23 B, 10, 11 and 12 of the OECD Model. In contrast, as regards the taxation of non-residents (outbound payments), there are no common rules provided by the CCCTB Directive. Nonetheless, under the CCCTB Directive, income of a permanent establishment situated in the CCCTB Member States and owned by a non-resident is subject to consolidation and formulary apportionment. This may contravene Art. 7 of the OECD, which attributes the income to a permanent establishment on the basis of the arm's length principle, and Art. 24 on non-discrimination as well. Moreover, a switch-over mechanism is established in Article 73 of the CCCTB directive, which may conflict with Art. 23 A of the OECD Model.

In the case where the third country with which the CCCTB Member State concluded a tax treaty is a developing country, current tax treaties usually contain a tax-sparing mechanism. Nonetheless, the CCCTB Directive does not provide for such a mechanism, which raises the possibility of contradiction, especially with the switch-over clause and credit method in the CCCTB.

Thin capitalisation rules and CFC rules are respectively drafted in Articles 81 and 82 of the CCCTB Directive, and these two measures may be in conflict with various provisions in the OECD Model, such as Arts. 7, 9, 10 and 24 of the OECD Model.<sup>1088</sup>

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<sup>1088</sup> European Commission, 'Company taxation in the Internal Market', COM (2001)582 final, p.397, it has been shown that most of these OECD provisions are in conflict with HST. However, conflict with these provisions is also relevant to the CCCTB system.



## 5.4 Interaction between the CCCTB rules and international tax agreements

In considering the compatibility of the CCCTB rules with double tax treaties based on the OECD Model, it is important to distinguish between double tax treaties entered into between the CCCTB-Member States themselves, and double tax treaties entered into between CCCTB-Member States and third countries.

### 5.4.1 Tax agreements between CCCTB-Member States

As regards tax treaties concluded between CCCTB-Member States, the CCCTB Directive explicitly states that these agreements will be overridden by the CCCTB provisions, particularly in respect to any agreement where the provisions are contrary to the CCCTB rules.<sup>1089</sup> This confirms the supremacy of the EC law.<sup>1090</sup> A typical pattern for this overriding is a treaty provision on exempting the income of a foreign permanent establishment (a permanent establishment located in another CCCTB Member State): this exemption will not be relevant because, as demonstrated before,<sup>1091</sup> the income of a permanent establishment in a Member State is entirely taxable and consolidated according to the CCCTB rules. Similarly, a treaty provision in relation to withholding tax on interest and other source taxation within CCCTB group members in different Member States will not be relevant, as under the CCCTB rules no withholding tax is levied on the payments between CCCTB-Member States.<sup>1092</sup>

On the other hand, tax treaties between Member States will still be applicable where there is no conflict with the CCCTB rules; for instance, a treaty restriction on withholding tax paid outside a CCCTB group, either to a non-CCCTB Member State or third country, would still limit any national withholding tax liability, since the CCCTB Directive does not disallow such withholding tax.<sup>1093</sup>

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<sup>1089</sup> Art.8 of the CCCTB Directive.

<sup>1090</sup> European Commission, 'Transaction and Dealing between the Group and Entities outside the Group', (CCCTB\RD\003\doc\en), para. 3.

<sup>1091</sup> See chapter 4, section 4.2.1.1

<sup>1092</sup> Art. 60 of the CCCTB Directive.

<sup>1093</sup> Art.77 of the CCCTB Directive.

#### **5.4.2 Tax treaties between CCCTB-Member States and third countries**

The CCCTB creates a common single tax system, in order to accommodate the current features of corporate tax systems of the internal market with its evolving economic integration. The CCCTB system is assumed to differ from the current domestic tax systems of the Member States upon which the current tax treaties with third countries are based.<sup>1094</sup> Therefore, an inconsistency between CCCTB rules and tax treaties concluded between Member States and third countries is envisaged. However, *the CCCTB Directive does not expressly state how to deal with such potential conflicts*. Assuming that the conflict arises, the solution can be approached in two possible ways: the short-term approach and solving the conflict in the long run.

#### **5.4.3 Short-term approach: A postponement of the conflict**

It has been suggested by the European Commission that the balance between providing an adequate level of protection of the tax base and minimum potential conflict with existing treaties should be considered in the CCCTB rules. However, it would be necessary to allow Member States, *in certain cases of conflict*, ‘to derogate temporarily in order to respect existing obligations under agreements with third countries’.<sup>1095</sup>

However, it is submitted that a partial derogation by CCCTB Member States in order to respect their obligations arising from tax treaties with third countries is not sufficient.<sup>1096</sup> This is because it is not consistent with international law, in particular certain provisions of the Vienna Convention on the Law of Treaties (VCTL), such as Arts. 26 and 27. The obligations arising from a treaty in force that has been concluded with a Member State is binding, and these obligations must be fulfilled in good faith (Art. 26 of VCTL). The CCCTB rules cannot be used to justify a Member State’s failure to

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<sup>1094</sup> European Commission, ‘Tax Treatment of Losses in Cross-Border Situations’ (Communication) COM (2006) 824 final p.4.

<sup>1095</sup> European Commission, ‘CCCTB: Possible Elements of a Technical Outline’, (CCCTB/WP057/doc/en), para .117.

<sup>1096</sup> Eric C.C.M. Kemmeren, ‘CCCTB and Exemption Method for PEs and Major Shareholding’ in, Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p.657.

comply with a double tax treaty with a third country (Art. 27 of VCTL).<sup>1097</sup> Thus it is not possible for the EU to compel its CCCTB Member States to violate their international obligation, even at a *minimal level*, in order to fulfil the CCCTB arrangements.<sup>1098</sup> Therefore, in the short run, a complete overriding by the tax treaties over the CCCTB rules is the only possible solution.

Accordingly, the short-term solution provides for a transitional period, in which the CCCTB Member States would be allowed to continue applying their current tax treaties with third countries, even if they contravene the CCCTB rules.<sup>1099</sup> Although the CCCTB Directive does not explicitly provide for such an approach, it can be inferred from some provisions in the CCCTB Directive, for instance Art. 6 (3)<sup>1100</sup> and Art. 76(5)<sup>1101</sup> imply that tax treaties negotiated between a Member State and a third country will prevail over the CCCTB arrangements. A reasonable justification for this solution is that it is not realistic at this stage to expect Member States to be willing and able to renegotiate all their tax treaties with third countries in order to be in line with the CCCTB rules applicable within the water's edge of the EU. This approach is seen as critical in order for the CCCTB system to operate before amending the tax treaties with third countries.<sup>1102</sup>

Moreover, the short-term approach, i.e. the prevalence of third country tax treaties over the CCCTB rules, is in line with Art. 351 of the TFEU. This Article governs disputes between Community law and bilateral tax treaties between a Member State and a third country which were concluded before the EC Treaty came into force. For this purpose it provides that 'The rights and obligations arising from agreements concluded [before the

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<sup>1097</sup> Vienna Convention on the Law of Treaties (Vienna 1969), United Nations 2005, available at <[untreaty.un.org/ilc/texts/instruments/.../conventions/1\\_1\\_1969.pdf](http://untreaty.un.org/ilc/texts/instruments/.../conventions/1_1_1969.pdf)> accessed 10 October 2012.

<sup>1098</sup> Eric C.C.M. Kemmeren, 'CCCTB and Exemption Method for PEs and Major Shareholding' in, Michael Lang, Pasquale Pistone, Josef Schuch, Clause Staringer (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p.657.

<sup>1099</sup> European Commission, 'Summary record of the Meeting of CCCTB' (2 July 2008 CCCTB/WP/68/en), para. 9; European Commission, 'Transaction and Dealing between the Group and Entities outside the Group', (CCCTB/RD\003\doc/en), para.3.

<sup>1100</sup> This article provides that a company will be considered as tax resident in a Member States according to the criteria provided therein unless the relevant tax treaty between such Member State and third country states otherwise, this can imply that tax treaty between third country and Member States prevails over the CCCTB rules.

<sup>1101</sup> In such Article, it is stated that [...] '*unless an agreement between the Member State of its residence and third country state otherwise*'.

<sup>1102</sup> European Commission, 'An overview of the main issues that emerged at the first meeting of the subgroup on international aspects' (CCCTB/WP\029\doc/en), p. 3.

entry into force of the EC Treaty] between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties”.<sup>1103</sup> Accordingly, in the event that incompatibility arises between third country tax treaties and Community law, Member States concerned *must take all appropriate steps to eliminate the incompatibilities established*, i.e. to amend their tax treaties with third countries to make such treaties consistent with the Community commitments they have taken on.<sup>1104</sup> The Member State involved must endeavour to renegotiate the provisions that are incompatible with Community law.<sup>1105</sup>

It can be noticed that the above provisions of the TFEU generally provide for the principle of non-retroactive application of laws.<sup>1106</sup> If the CCCTB is considered to be a part of the EC law, however, it is secondary community legislation; it cannot override any third-country tax treaties which were concluded before the entry of the CCCTB into force. Thus, any incompatibility between the CCCTB rules and existing third-country tax treaties will have to be resolved in the long term.

However, this approach would undermine the CCCTB objective by which all taxpayers are subject to a common set of rules within the CCCTB jurisdiction. Unlike the interaction between national tax legislation of a certain Member State and its double tax treaty in respect to a third country, the interaction between the CCCTB rules and third-country double tax treaties does not have a bilateral basis. The consolidated group members are located in several different Member States, and each Member State has its own network of tax treaties with third countries. These tax treaties contain various tax treatments depending on the country in which the income is sourced, and also on how the tax treaty between the third country and the respective Member State has been negotiated. Some of these rules are consistent with the CCCTB ones, but in other cases they may vary. In other words, the CCCTB rules will be impacted by more than one tax treaty in relation to one third country, i.e. several different tax treaties would modify the CCCTB rules, and this would infringe the very concept of having a common tax

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<sup>1103</sup> Art. 351 (1) of the TFEU.

<sup>1104</sup> Art. 351 (2) of the TFEU; Similarly see Dennis Weber, Antonio Russo, ‘The ‘Switch-over’ Clause’ in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), p.766

<sup>1105</sup> European Commission, ‘EC law and Tax Treaties’, (9 June 2005, DOC (05) 2306), p.8.

<sup>1106</sup> Pasquale Pistone, *The Impact of Community law on Tax Treaties: Issues and Solutions* (Kluwer Law International 2002), p.88.

base.<sup>1107</sup> However, insofar as the CCCTB rules are in line with the international tax law norms, the impact of conflict between tax treaties and CCCTB rules would be alleviated and the short-term approach would be workable.

#### **5.4.4 Long-term approach: a request for optimal solutions**

In the long run, in order for the CCCTB system to operate effectively, to make the EU function as a real Internal Market and to bring the objectives behind the CCCTB Directive in line with the tax treaties concluded between CCCTB Member States and third countries, it will be critical for the CCCTB Member States to renegotiate their tax treaties with third countries in respect of corporate taxation provisions.<sup>1108</sup> It is submitted that the amendment of current tax treaties with third countries should be only a last resort. This is for two reasons: the renegotiation of a tax treaty is usually a protracted procedure, and moreover it would be more difficult for the treaty partner who initiates it, as the other treaty partner is not likely to respond affirmatively or flexibly to the first treaty partner's requirements.<sup>1109</sup> It is therefore imperative to identify the tax treaty provisions of which the CCCTB rules would be in breach.

#### **5.5 Areas of potential conflict between the CCCTB rules and third-country double tax treaties**

As most of the CCCTB rules, which apply in the international context, have a double tax treaty dimension, the following discussion examines the issues relevant to the question of compatibility of the CCCTB rules with double tax treaties entered into between CCCTB-Member States and third countries.

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<sup>1107</sup> European Commission, 'An overview of the main issues that emerged at the first meeting of the subgroup on international aspects' (CCCTB\WP\029\doc\en), p. 3.

<sup>1108</sup> *Ibid.*, p. 4.

<sup>1109</sup> *Ibid.*

### 5.5.1 Conflict in respect to transfer pricing rules – Article 9

As established in Chapter 3, it is due to the rejection of the worldwide consolidation and formulary apportionment<sup>1110</sup> that consolidation and subsequent apportionment are limited to the water's edge of the EU,<sup>1111</sup> whereby an entity resident in a third country is not eligible to become a member of a consolidated group in the EU.<sup>1112</sup> Nonetheless, transactions between members of an EU-consolidated group and their associated enterprise in a third country will continue to be priced on an arm's length basis.<sup>1113</sup> Indeed, the CCCTB Directive lays down the arm's length principle,<sup>1114</sup> which permits an increase in profits where the conditions regulated between the associated enterprises are different from what would be applicable between independent parties.

The CCCTB-formulary apportionment water's edge would be problematic as the coexistence of formulary apportionment in the EU and separate accounting vis-à-vis third countries would imply the reintroduction of the same complexities that the adoption of formulary apportionment would putatively do away with. This problem will be more complex because of the diversity in application of the transfer pricing rules in the European Member States. This implies that if the CCCTB Directive provides for a common approach in respect to the arm's length principle applicable by all CCCTB-Member States, the problem will be alleviated.

Based on the OECD Model,<sup>1115</sup> it can be noticed that the CCCTB arm's length principle follows Article 9 of the OECD Model. There is no explicit reference made to the OECD Model, as not all Member States participate in the OECD, and further the text of the

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<sup>1110</sup> Joann M. Weiner, 'Using the experience of the US States to evaluate issues in implementing formula apportionment at the international level', Office of Tax Analysis, US department of the Treasury, OTA Paper 83, April 1999,p.8.

<sup>1111</sup> European Commission communication, (26 June 1992, SEC (92) 1118) final, p.9.

<sup>1112</sup> Arts. 55, 57, 86 of the CCCTB Directive.

<sup>1113</sup> Art. 78 of the CCCTB Directive; European Commission, 'CCCTB: Possible Elements of a Technical Outline' (26 July 2007, CCCTB/WP057/doc/en), Para. 78; European Commission, 'Transaction and Dealing between the Group and Entities outside the Group' (CCCTB\RD\003\doc\en), paras.16-21.

<sup>1114</sup> Art. 79 of the CCCTB Directive.

<sup>1115</sup> Art. 9 of the OECD Model reads as:

'where [...] conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'.

Model is not available in all languages.<sup>1116</sup> Moreover, for the purpose of applying the transfer pricing rules in the CCCTB, a taxpayer resident in the CCCTB jurisdiction is regarded as an associated enterprise in relation to its permanent establishment located in a third country, and vice versa.<sup>1117</sup> This is largely in line with the OECD approach on the determination of profits attributable to a permanent establishment in respect to its dealings with other enterprises,<sup>1118</sup> i.e. the head office.<sup>1119</sup> Therefore, it can be said that the transfer pricing rules provided in the CCCTB are consistent with Art. 7(2) of the OECD Model on the attribution of the business income to a permanent establishment, and are also in line with Art. 9 of the OECD Model in general.

Since the double tax treaties with third countries adopt the arm's length principle under the OECD Model, providing an identical transfer pricing rules in the CCCTB would not therefore necessitate the renegotiation of the current tax treaties with third countries in respect to provisions similar to Art. 9 and Art.7 (2) of the OECD Model.<sup>1120</sup> However, the CCCTB Directive does not contain a provision similar to Art. 9 (2) of the OECD Model.<sup>1121</sup>

Moreover, the adjustment made to the transactions of the associated enterprise in accordance with the transfer pricing rules in the CCCTB would result in an economic double taxation. This is because the adjusted amount of profits, which is accordingly taxable in the hands of an enterprise in a contracting state, has been already taxed in the

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<sup>1116</sup> European Commission, 'Transaction and Dealing between the Group and Entities outside the Group' (CCCTB\RD\003\doc\en), para.71.

<sup>1117</sup> Art. 78(1) of the CCCTB Directive; OECD, 2010 Report on the Attribution of Profits to Permanent Establishments. Available at <<http://www.oecd.org/dataoecd/23/41/45689524.pdf>> accessed 20 August 2012.

<sup>1118</sup> Commentary to Art. (2) OECD Model 2010, para.15.

<sup>1119</sup> The principle provided in the OECD Model on the determination of a permanent establishment income is as follow '[...] The determination of the profits that are attributable to the permanent establishment [...] these profits are the profits that the permanent establishment is might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions'.

<sup>1120</sup> Stefan Mayor, *Formulary Apportionment for the Internal Market* (IBDF 2009), p.257.

<sup>1121</sup> Art.9(2) of the OECD Model reads as:

'Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.'

hands of its associated enterprise in the other contracting state, i.e. the same income is taxed in the hands of different persons.<sup>1122</sup> In accordance with the OECD Model, the other contracting state in which the profits adjustment did not take place has to make an appropriate adjustment to prevent the economic double taxation in the case where the adjustment carried out in the first contracting state is justified both in principle and in amount. The CCCTB Directive stipulates neither the principle nor the mechanism for the elimination of such double taxation.<sup>1123</sup> In contrast to the OECD Model, the CCCTB Directive does not stipulate the elimination of the economic double taxation. Moreover, similar to the OECD position, the treatment of what is called ‘secondary adjustment’ is not provided in the CCCTB Directive.<sup>1124</sup>

Furthermore, the coexistence of CCCTB-formulary apportionment and the arm’s length principle in relation to third countries will be more complex due to the diversity of application of the transfer pricing rules in the European Member States. Currently, Member States adopt different transfer pricing rules and documentation requirements. This makes transfer pricing a complex issue for multinational enterprises operating within the EU and third countries.<sup>1125</sup> Although recently there has been a growing trend towards a comprehensive approach with regard to the documentation requirements and transfer pricing procedures, particularly in the form of advance pricing arrangement and mutual agreement procedures, common transfer pricing rules are still absent among Member States. Consequently, problems caused by transfer pricing, such as double taxation and high compliance cost, have still not been completely eliminated.<sup>1126</sup>

It is argued that such problems can be alleviated by adopting the OECD Transfer Pricing Guidelines for Multinational enterprises and Tax Administrations, and the recommendations made by the EU Joint Transfer Pricing Forum in this respect.<sup>1127</sup> Nonetheless, these guidelines and recommendation are considered as a ‘soft-law’, i.e. not binding on Member States and third countries. This will raise the question of

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<sup>1122</sup> Commentary to Art 9(2) OECD Model, 2010, para. 5.

<sup>1123</sup> *Ibid*, para. 6.

<sup>1124</sup> *Ibid*, para. 8.

<sup>1125</sup> Jesper Barenfeld, ‘A Common Consolidated Corporate Tax Base in the European Union a Beauty or a Beast in the quest for tax Simplicity’, *Bulletin for International Taxation*, July 2007, p.267.

<sup>1126</sup> *Ibid*.

<sup>1127</sup> Marc Bourgeois, Eric Von Frenckell, ‘Relation to Taxpayers outside the Group’ in in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), pp.195,202.



whether providing common transfer pricing rules to be applied between the CCCTB Member and third countries could bring an end to the above-mentioned problems. This solution would allow the entire group of the CCCTB to follow one set of documentation requirements for transfer pricing. The uniformity objective of the CCCTB would be achieved under such an approach. In other words, following different transfer pricing rules in relation to third countries, depending on the Member State in which a CCCTB group member is situated, would undermine the CCCTB objective of simplification and the reduction of compliance cost.<sup>1128</sup>

However, technically, as outlined above, the current CCCTB Directive *does not provide for a common transfer pricing regime*, it merely lay down the arm's length principle; there is no provision for the elimination of economic double taxation or secondary adjustment and there is no reference to a single set of documentation rules.<sup>1129</sup> The stance of the CCCTB Directive in this regard can be justified on the basis that a common transfer pricing approach is too ambitious from a political point of view at this stage.<sup>1130</sup>

In any case, having mentioned the endorsement of the 'functionally separate entity' approach, under Art. 7 of the OECD Model and the adoption of the arm's length concept under the CCCTB Directive in relation to third countries, it seems crucial for the CCCTB-Member States and third countries to examine how to coordinate between the application of formulary apportionment within the CCCTB group and the separate entity approach vis-à-vis third countries.<sup>1131</sup> In this respect, attention could be focused on the profit-split methods for transfer pricing, instead of the traditional arm's length

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<sup>1128</sup> Marc Bourgeois, Eric Von Frenckell, 'Relation to Taxpayers outside the Group' in in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), pp.195,202.

<sup>1129</sup> In the context of the HST, it has been suggested that 'a careful distinction should be made between primary and secondary corresponding adjustments. In particular, it seems advisable to make corresponding adjustments after the tax base allocation is carried out and not before. This is because only the (foreign-sourced) income of that affiliate and only the Member State responsible for the negotiation should be affected', see European Commission 'Tackling the Corporation Tax Obstacles of Small and Medium-sized Enterprises in the Internal Market – outline of a Possible Home State Taxation Pilot Scheme', COM (2005)702 final, para. 26.

<sup>1130</sup> Marc Bourgeois, Eric Von Frenckell, 'Relation to Taxpayers outside the Group' in in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), pp.195,203.

<sup>1131</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.25.

methods.<sup>1132</sup> The profit-split method uses certain income generation factors as a basis for income allocation, i.e. it is similar to the CCCTB-formulary apportionment.<sup>1133</sup> Moreover, some scholars define formulary apportionment as an approach upon which the CCCTB-Member States agreed ‘*to transfer a part of their taxing rights under existing tax treaties from those states who are attributed less under formulary apportionment than under separate accounting to those which are attributed more*’.<sup>1134</sup>

The transferring of taxing rights between the CCCTB Member States is not prohibited by international tax law.<sup>1135</sup> Therefore, applying the formulary apportionment within the CCCTB jurisdiction is not regarded as a rejection of the arm’s length principle which is applicable in relation to third countries. Rather, separate accounting is still a focal element in the determination of the profits apportionable within the CCCTB group. In this regard, the effect of the formulary apportionment (split of the consolidated tax base) would be the redistribution of source taxing rights, which would have been carried out under the arm’s length principle, to the CCCTB-Member States.<sup>1136</sup> The definition of the formulary apportionment in such a way reveals the possibility of coordination between CCCTB-formulary apportionment and separate accounting under the arm’s length principle applicable in the third-countries’ double tax treaties.<sup>1137</sup>

Therefore, improving and developing current OECD guidelines on the arm’s length principle into a profit-split mechanism, and including it in the CCCTB Directive as a common approach applicable to third countries could be a solution. In the case where this solution is included in the CCCTB Directive, it would have an effective impact on the CCCTB Member States’ coordination in this respect. However, under this approach, renegotiation of the current tax treaties with third countries will be required in the long run. It should be stressed that in-depth examination of reconciliation between the formulary apportionment and separate accounting approach is beyond the scope of this research.

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<sup>1132</sup> Christiana HJI Panayi, ‘The Common Consolidated Corporate Tax Base and the UK Tax System’ (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.25.

<sup>1133</sup> See KPMG Guide to CCCTB Part III, p.8 available at <<http://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/ccctb-guide-3.aspx>> accessed 20 February 2012.

<sup>1134</sup> Stefan Mayor, ‘*Formulary Apportionment for the Internal Market*’ (IBDF 2009), p.185.

<sup>1135</sup> *Ibid*, p.256.

<sup>1136</sup> *Ibid*, p.185.

<sup>1137</sup> *Ibid*.

### 5.5.2 Compatibility in respect to tax treatment of outbound payments – taxation of non-residents

As established in Chapter 4, income derived by foreign-based affiliates from the CCCTB jurisdiction is subject to consolidation and subsequent apportionment.<sup>1138</sup> However, the inclusion and taxation of such income raises issues of compatibility with existing rules of international taxation which are based on residence or source principle.

*Firstly*, if the foreign affiliate is deriving passive types of income such as dividends, interest and royalties from the CCCTB jurisdiction, i.e. payments made from a taxpayer subsidiary to a parent company resident in a third country, the relevant tax treaty provisions which assign a limited taxing right to the source country would be frustrated. In other words, consolidation and apportionment of dividends, interest and royalties which are sourced in the EU by foreign-based subsidiaries would not negate the existing tax treaties, as foreign-based subsidiaries are taxed as residents<sup>1139</sup> and included in the consolidated group when they fulfil consolidation-qualifying conditions.<sup>1140</sup> Nevertheless, imposing withholding tax on such payments at ordinary rate (non-tax treaty rate) would be in breach of treaty provisions equivalent to Art.10 (2), Art.11 (2) and Art.12 (1) of the OECD Model. This is because these articles attribute limited taxation rights to the source country.<sup>1141</sup>

In order to eliminate this incompatibility, the CCCTB Directive stipulates that withholding taxes and other source taxation on outgoing payments would continue to be subject to the tax rate applicable in the relevant tax treaty between the CCCTB-Member State of the payer and the third country of the recipient.<sup>1142</sup> This interim solution implies that the CCCTB Directive does not intend to lay down common rules for withholding taxes on outbound passive income. In the long run, however, the outbound payments of

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<sup>1138</sup> Art.55 of the CCCTB Directive; European Commission, 'The design of an Apportionment Mechanism for an EU Consolidated Tax Base', 13 February 2004, DOC (04)1404, p.9.

<sup>1139</sup> Wattel, Peter J, 'Corporate Tax Jurisdiction in the EU with respect to the Branches and Subsidiaries; Dislocation distinguished from Discrimination and Disparity; a Plea for Territoriality', EC tax review, The Hague, Vol. 12 (2003), no. 4, pp. 194-202

<sup>1140</sup> Art.54 of the CCCTB Directive.

<sup>1141</sup> Antonio Russo, 'Formulary Apportionment for Europe: An Analysis and A proposal', Intertax, Vol. 33, No. 1, 2005, pp.2-30 at 15.

<sup>1142</sup> Art.77 of the CCCTB Directive

passive-type income would need to be treated under a common basis in order to achieve the CCCTB's uniformity objective.

At the EU level, as a result of the free movement of capital which increased the competition between countries and in an attempt to stimulate international financial flow, withholding taxes on outbound interest paid to non-residents have been gradually abolished in most European countries.<sup>1143</sup> Moreover, withholding taxes on outbound dividends have been gradually eliminated within the EU in respect to inter-company dividends from substantial shareholders, i.e. FDI equity flows. This was mainly due to the implementation of the EC Parent-Subsidiary Directive as from 2009.<sup>1144</sup> However, withholding taxes remain applicable for outbound portfolio dividends within the EU. Moreover, withholding taxes would be entirely prevented among the members of a consolidated group under the CCCTB system,<sup>1145</sup> either for portfolio investment or FDI equity flows.<sup>1146</sup>

On the other hand, dividends paid to residents in third countries are in most cases still subject to withholding taxes. Nonetheless, several EU-Member States have extended the exemption of withholding taxes in respect to dividends paid to companies resident in third countries, either in order to promote their international competitiveness or to be consistent with ECJ jurisprudence.<sup>1147</sup> For example, the Netherlands exempted dividends paid to foreign companies, provided that such a company participates in at least 5% of the Netherlands companies; this exemption was in response to the ECJ's remarks.<sup>1148</sup> Furthermore, in Luxembourg, dividends paid to a parent company resident in a third country, with which Luxembourg has a tax treaty, is exempted from withholding tax. This exemption is on condition that the parent company holds at least

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<sup>1143</sup> Antonella Maglic and Alessandara San, 'Should Outbound Dividends Remain Taxed at Source in the European Union? Some Hints from the Italian Example', *European Taxation*, April 2009, pp199-214, at 200.

<sup>1144</sup> Council Directive 90/435/EEC of 23 July 1990.

<sup>1145</sup> Art. 59 of the CCCTB Directive.

<sup>1146</sup> For discussion of the differences, effects and trade-off between FDI and FPI see Goldstein Itay and Assaf Razin, 'Foreign Direct Investment vs. Foreign Portfolio Investment' (2005) Working Paper 11047, National Bureau of Economic Research, Cambridge, available at <<http://www.nber.org/papers/w11047>> accessed 12 November 2012.

<sup>1147</sup> Gerard T.K. Meussen, 'Denkavit International: The Practical Issues', *European Taxation*, May 2007, p. 241.

<sup>1148</sup> ECJ Case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam*, [2007] ECR I-09569, paras, 18 and 28; For more discussion on the withholding tax exemption in Netherlands see Dick E. van Sprundel, 'An analysis of the Netherlands Dividend Withholding Tax on share: No need to Abolish this Tax yet?' *European Taxation*, December 2008, pp.607-618.

10% of the Luxembourg subsidiary for a one year period. Belgium national tax law provides for a withholding tax exemption in respect to dividends paid to companies incorporated in a tax treaty countries; subject to 15% participation and one-year period of holding.<sup>1149</sup> Several other countries are reducing withholding tax rates on dividends paid to all foreign investors to levels equal to the ones provided in tax treaties. For instance, in 2009 the Czech Republic reduced withholding taxes on dividends from 15% to 12.5%. In Denmark, the withholding tax on dividends paid to foreign investors resident in tax treaty countries and holding 10% of the Danish subsidiary was reduced from 28% to 15%.<sup>1150</sup>

Against the endorsement of the elimination of withholding taxes and a reduction in the EU with regard to outgoing interest and dividends, it can be suggested that the CCCTB should provide for a common reduced withholding tax rate. The withholding tax rate could be decreased to levels that are equal to the ones prevailing in the current tax treaties concluded with third countries. This solution would be sufficient, as it does not necessitate an immediate renegotiation of the relevant third-country tax treaties.

*Secondly*, if a company resident in a third country derives business income from a CCCTB Member State, in accordance with tax treaty law (Art.7 of the OECD) the source Member State will not be able to tax business income of a non-resident unless it is sufficiently connected to its jurisdiction. Where the sufficient nexus is represented in the form of a permanent establishment, then the business income of this EU-permanent establishment, which is owned by a non-resident, can be taxed according to the CCCTB system.<sup>1151</sup> However, taxing an EU-permanent establishment raise the question of how much income should be attributed to it. This leads to the compatibility question of CCCTB formulary apportionment with the current tax treaty standard, i.e. the arm's length principle. This problem will be examined in depth in the section that follows.

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<sup>1149</sup> Antonella Maglic and Alessandara San, 'Should Outbound Dividends Remain Taxed at Source in the European Union? Some Hints from the Italian Example', *European Taxation*, April 2009, pp199-214, at 211.

<sup>1150</sup> *Ibid.*

<sup>1151</sup> Art.6 (7) of the CCCTB Directive.

### 5.5.2.1 Taxing EU-permanent establishment income: Articles 7 and 24 of the OECD Model

As established earlier, a company resident in a third country (head office) can opt for the CCCTB scheme in respect to its permanent establishment located in a CCCTB-Member State.<sup>1152</sup> The EU-permanent establishment will be subject to the CCCTB system and consequently its profits will be determined and taxed according to the CCCTB rules. Where the EU-permanent establishment qualifies as a group member, its income will be subject to consolidation and CCCTB-formulary apportionment.<sup>1153</sup> If there is a tax treaty between the CCCTB Member State where the permanent establishment is located and the third country of the head office, the question arises as to what extent the provisions incorporated in the tax treaty, which regulate the taxation of permanent establishment (Art.7 of the OECD), can be affected by the CCCTB rules on permanent establishment taxation. Therefore, the taxation of an EU permanent establishment must be considered in the light of Arts. 7 and 24 of the OECD Model.

In principle, Article 7(1)<sup>1154</sup> of the OECD Model contains rules for allocating taxing rights over business profits, which are obtained in a host country by an enterprise resident in another contracting state.<sup>1155</sup> The article states that business profits sourced in a host country by an enterprise resident in *another country* are not taxable in the *host country* (i.e. rather they are taxable in the enterprise's residence country) unless such

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<sup>1152</sup> Art.6 (7) of the CCCTB Directive.

<sup>1153</sup> Art. 55 and 57(1) of the CCCTB Directive.

<sup>1154</sup> The new Art.7(1) of the OECD Model reads as follows:

‘Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with provision of paragraph 2 may be taxed in that other state’.

The replacement of Art. 7 was an answer to the uncertainty from which the taxpayer and tax authorities suffered in respect to attributing profits to permanent establishment, as there was no consensus interpretation of the former Art.7 of the OECD MC, which would invoke the existence of double taxation and under taxation, for a comprehensive discussion on the replacement of article 7 of the OECD MC see Michael Kobetsky, *International Taxation of Permanent Establishment*(Cambridge University Press 2011), p.351 et seq.

<sup>1155</sup> It is stated that Art.7 significantly facilitate cross-border investment by reducing double or incongruous taxation , for the purposes of Article 7 of the OECD Model, and the involvement of the OECD's project of the attribution of profits to a permanent establishment in particular its policy 's objectives, see Mary C. Bennett & Carol A. Dunahoo, 'The Attribution of Profits to a Permanent Establishment: Issues and Recommendations' , Intertax , Vol. 33, No. 1, 2005,p. 51; Michael Kobetsky, *International Taxation of Permanent Establishment*(Cambridge University Press 2011), p.351 et seq.

profits are gained through a permanent establishment located therein.<sup>1156</sup> Accordingly, if the enterprise resident in the other contracting state derives business profits in the host country through a permanent establishment, the host country is entitled to the tax only on so much of the profits as are attributable to the permanent establishment.<sup>1157</sup>

Since the third country head office is carrying out business in the CCCTB Member State through a permanent establishment, this Member State is entitled to tax the profits of the permanent establishment. To this extent, the CCCTB rules on permanent establishment taxation seem to be in line with Art.7 (1). However, this taxing right is confined to the income attributable to the permanent establishment. The permissible means of attributing business profits to a permanent establishment is contained in Art. 7(2).<sup>1158</sup>

Under Art.7 (2) the attribution of a permanent establishment's profits is conducted pursuant to the arm's length principle,<sup>1159</sup> under which the profits attributable to a permanent establishment are the profits it would expect to attain if it were a separate and independent enterprise involved in the same or similar activities under the same or similar terms.<sup>1160</sup> This principle applies in relation to the transactions between the permanent establishment and the other parts of the enterprise,<sup>1161</sup> as well as transactions with independent enterprises and transactions with associated enterprises.<sup>1162</sup> Thus, on a *legal fiction* basis, the permanent establishment is hypothesised as a separate and independent enterprise for the purposes of determining which profits are attributable to it. This facet of the *legal fiction* corresponds to the arm's length principle, on which

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<sup>1156</sup> Commentary to Art. 7(1) OECD Model, 2010 paras.10-11.

<sup>1157</sup> *Ibid*, para. 12.

<sup>1158</sup> The new Art. 7(2) of the OECD Model, stipulates in part:

‘For the purposes of this Article and Article [23 A] [23 B], the profits that attributable in each contracting state to the permanent establishment referred to in paragraph 1, are the profits it might be expected to make, in particular in its dealing with other parts of the enterprises, if it were a separate and independent enterprise engaged in the same e or similar activities under the same or similar conditions...’.

<sup>1159</sup> There are a variety of approaches in respect to attributing income to a permanent establishment, according to one main approach, all income, which is economically linked to a permanent establishment's activities or assets is considered to be attributable to the permanent establishment. Under other basic approach, the income which is sourced in the country where the permanent establishment situated is attributed to it regardless of the existence of the economic connection, this approach is referred to as ‘force of attraction approach’. See Hugh J. Ault, Brian J. Arnold, Guy Gest, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International, the Netherlands, 2010), pp. 395-400.

<sup>1160</sup> Commentary to Art 7(2) OECD Model, 2010, para. 15.

<sup>1161</sup> *Ibid*.

<sup>1162</sup> *Ibid*, para. 20.

Art.9 of the OECD Model is based, for the purposes of allocating the profits between associated enterprises.<sup>1163</sup>

In accordance with Art.7 (2), the profits attributable to the permanent establishment from an international enterprise's profits are determined as if it were a separate and independent enterprise.<sup>1164</sup> However, the provision does not stipulate *the apportionment of the overall profits of the whole international enterprise to the permanent establishment and its other related parts*. Accordingly, profits may be attributed to the permanent establishment albeit the international enterprise has operated at a loss.<sup>1165</sup> In contrast, the permanent establishment may not be attributed any profits even though the international enterprise as a whole has made profits.<sup>1166</sup>

It has been acknowledged that the application of Art.7 (2) is relevant to both the residence country of the head office and the country that hosts the permanent establishment. The residence country has an interest in the provision being applied correctly and consistently because it touches upon its taxing right over the business profits. If Art.7 (2) is not correctly applied by the country where the permanent establishment is located, it may result in double taxation, which occurs when the host country taxes the profits which are not attributable to the permanent establishment under Art.7 (2), as the residence country of the head office has the exclusive taxing right over the profits that are not attributable to a permanent establishment.<sup>1167</sup>

Moreover, the taxing right given to the host country over the profits attributable to the permanent establishment situated therein is not an exclusive one. It is a taxing right that is shared between the host country and the residence country of the head office, meaning that the residence country may tax the profits attributable to the permanent establishment.<sup>1168</sup> However, under Arts. 23 A and 23 B of the OECD Model, the

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<sup>1163</sup> Commentary to Art 7(2) OECD Model, 2010, para.16.

<sup>1164</sup> *Ibid.*

<sup>1165</sup> *Ibid*, para.17.

<sup>1166</sup> As a result of applying separate accounting approach, which considers a permanent t establishment as a separate entity from its head office, the international enterprise is not allowed to offset the taxable profits attributable to the permanent establishment in the hosting country (source country) with losses incurred in the head offices' residence country or *vice versa*.

<sup>1167</sup> Michael Kobetsky, *International Taxation of Permanent Establishment* (Cambridge University Press 2011), p.366.

<sup>1168</sup> *Ibid.*



residence country is required to prevent any double taxation resulting from taxing the profits attributable to the permanent establishment. Accordingly, it may eliminate double taxation by providing a tax credit for the taxes imposed on the profits attributable to the permanent establishment in the host country; alternatively, it can exempt the profits attributable to the permanent establishment from taxation.<sup>1169</sup> In order to be able to provide relief from double taxation either by the credit or exemption method, the residence country is required to determine the profits which are attributable to the permanent establishment. Similarly, the host country is required to determine the profits that are attributable to the permanent establishment in order to be able to tax such profits.<sup>1170</sup> Therefore, the provision applies to both the head office's residence country and the host country.

Where there is an OECD-based tax treaty in force between a CCCTB-Member State and third country, the tax liability of the EU-permanent establishment is normally computed pursuant to the applicable tax treaty, i.e. on an arm's length basis. On the other hand, the taxable income attributable to such permanent establishment is determined through the CCCTB-formulary apportionment. The third country in which the permanent establishment's head office is placed may find such practice to be in breach of the underlying tax treaty, and it would claim for a breach of international obligations secured under a double tax treaty. In effect, this practice infringes the third-country double tax treaty when the taxable profits allocated to the permanent establishment through formulary apportionment are higher than the permanent establishment's tax liability on the arm's length basis;<sup>1171</sup> this is problematic to the third country, particularly when it subjects the income attributable to the permanent establishment to the residence taxation and relieves double taxation by the credit method, which means that it would have to grant a higher amount of credit, and thus its taxable share would shrivel.

***A short-term solution*** for the above situation would be to override the arm's length method in certain cases. In other words, where the existing tax treaty concluded

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<sup>1169</sup> Commentary to Art 7(2) OECD Model, 2010 para. 27.

<sup>1170</sup> *Ibid*, para. 18.

<sup>1171</sup> For more clarification on the mismatch between the formulary apportionment's results and arm's length's results, see a numerical example provided in Stefan Mayor, *Formulary Apportionment for the Internal Market* (IBFD 2009), p.258.

between the third country and the Member State attributes profits to an EU-permanent establishment according to the arm's length principle, the arm's length rule would override formulary apportionment *only in respect to the obligation of the third country to give relief for double taxation*.<sup>1172</sup> Consequently, when double taxation is relieved by the credit method in the third country, the amount of such credit would be limited to the level of an 'arm's length' attribution of profits to the EU-permanent establishment.<sup>1173</sup> This approach is seen to be workable in respect to a third country that operates an ordinary credit method, especially where that country has a higher level of taxation than the one that is borne by the permanent establishment in the CCCTB jurisdiction.<sup>1174</sup>

However, under this approach the Member State where the permanent establishment is situated would still be able to tax more than the amount calculated on an arm's length basis. Therefore, double taxation would be inevitable by virtue of the overlap between the permanent establishment's tax liability computed under formulary apportionment and its tax liability under the arm's length rule,<sup>1175</sup> meaning that the parallel use of formulary apportionment and separate entity accounting would cause double taxation.

Furthermore, this approach does not consider the situation where the CCCTB-formulary apportionment results in a tax base lower than arm's length tax base being attributed to the EU-permanent establishment. Nevertheless, it is submitted that where the CCCTB tax base allocated to the EU-permanent establishment is less than it would be under the arm's length principle, the head office's third country would only give credit for the actual CCCTB tax paid.<sup>1176</sup> In this respect, a possible short-term solution is to convince the third-country residence of the head office to exempt the income of the EU-permanent establishment, either by domestic law or under a tax treaty. In this respect, attributing the income to the CCCTB-permanent establishment by formulary

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<sup>1172</sup> European Commission, 'Transaction and Dealing between the Group and Entities outside the Group' (CCCTB\RD\003\doc\en), para.4.

<sup>1173</sup> *Ibid.*

<sup>1174</sup> Philip Baker & Ioanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Stringer (eds.), *Common Consolidated Corporate Tax Base* (Linde 2008), p.648.

<sup>1175</sup> *Ibid.*

<sup>1176</sup> European Business Initiative on Taxation (EBIT), 'Contribution to the European Commission Workshop on the CCCTB', 20 October 2010, p.5

apportionment would not raise any difficulties as the third country's revenues would not be affected.<sup>1177</sup>

Despite the fact that this approach attempts in a practical way to resolve the problems resulting from the conflict between CCCTB-formulary apportionment and the arm's length principle, nonetheless, from a theoretical perspective, attributing income to the EU-permanent establishment pursuant to formulary apportionment still contravenes Art.7 of the OECD Model, as convincing a third country to switch into the exemption method falls under the scope of Art. 23B of the OECD Model. Therefore, this dispute has to be approached from a long-term perspective.

It has been believed that recourse to Art. 7(4) could offer some solution.<sup>1178</sup> The former Art.7<sup>1179</sup> of the OECD Model contained a provision that provided for alternative allocation methods of attributing the profits to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts.<sup>1180</sup> Nevertheless, the former provision required certain conditions for the use of the alternative apportionment method; namely, it has been customary, it involves the apportionment the total profits of the international enterprises to its various parts including the permanent establishment, and it results in figures that are in accordance with the arm's length principle. These three conditions will be tested against the CCCTB formulary apportionment.

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<sup>1177</sup> Christiana HJI Panayi, 'The Common Consolidated Corporate Tax Base and the UK Tax System' (2011) The Institute for Fiscal Studies Discussion TLRC Discussion Paper No. 9, p.68.

<sup>1178</sup> *Ibid.*

<sup>1178</sup> European Commission, 'The territorial Scope of the CCCTB' (CCCTB\WP\026\doc\en), para. 34.

<sup>1179</sup> The former paragraph read as follows:

'Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article'.

However, this paragraph is deleted because the method contained in it was rarely used and it was difficult to ensure that its results would comply with the arm's length principle. See Commentary to Art 7(2) OECD Model, 2010 para. 41

<sup>1180</sup> The most important implication of this method, in contrary to the separate accounting approach, is that the income attributable to the permanent establishment's activities can be offset against losses incurred by, for instance, the head office resident in another country. See Paolo Arginelli, 'The Discriminatory Taxation of Permanent Establishments by the Host State in the European Union: a Too Much Separate Entity Approach' *Intertax*, Vol. 35, No. 2, 2007, pp. 82-91 at 83.

***Apportionment method will result in figures in accordance with the arm's length principle***

The former Article 7(4) stipulated that the alternative method of profits apportionment must result in figures that are in accordance with the arm's length principle.<sup>1181</sup> This raises the question of whether the figures obtained under the CCCTB-formulary apportionment accord with the separate entity approach, which is the primary method for profit attribution provided in Art.7(2). This requires determining to *what extent* the results calculated pursuant to the CCCTB's formulary apportionment have to be in conformance with the figures which would have been obtained if the separate entity approach had been used.

It is admitted that an alternative method based on an apportionment of the total profits of an international enterprise is likely to produce results that may be different from results based on the separate entity approach.<sup>1182</sup> Nevertheless, it is considered that such an alternative method, which involves the apportionment of the total profits, should aim to produce 'figures of taxable profits that approximate *as closely as possible* to the figures that would have been produced under separate account rules...'.<sup>1183</sup> In other words, the contracting states are not given the latitude to adopt any alternative method without any limitations.<sup>1184</sup> As regards the CCCTB situation, it is expected that there would be a *wide scope* between the results obtained under the CCCTB-formulary apportionment and the results that would have been attained pursuant to the separate entity approach.<sup>1185</sup> Moreover, ensuring that the results of the CCCTB-formulary apportionment are in conformity with the arm's length principle ones raises difficulties in practical terms.<sup>1186</sup>

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<sup>1181</sup> Commentary to Art 7(4) OECD Model, 2008 para.52.

<sup>1182</sup> *Ibid.*

<sup>1183</sup> *Ibid.*, para. 54.

<sup>1184</sup> It is submitted that a degree of correspondence between the results obtained under the two methods would be satisfactory, because requiring a close correspondence between the results based on the primary method (separate accounting) and the alternative method (income attribution on the basis of apportionment of the total profits) would negate the purpose of Art.7 (4) of allowing for an alternative method, see Sven-Olof Lodin & Malcolm Gammie, *Home State taxation* (IBFD 2001), p.93.

<sup>1185</sup> Johanna Hey, 'EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity' (2008) New York University School of Law, Working Paper 02/08, p.50, available at <centers.law.nyu.edu/jeanmonnet/papers/08/080201.pdf> accessed 20 December 2012.

<sup>1186</sup> Commentary to Art 7(2) OECD MC 2010 paragraph 41.

Additionally, Art.7 (4) required that the alternative method for the determination of the permanent establishment income has to involve the *apportionment of the total profits of the international enterprise to its various parts* including the permanent establishment. It can be said the CCCTB-formulary apportionment would satisfy this condition as it involves the apportionment of the profits of the whole group to the group members including the permanent establishment.

Furthermore, Art.7 (4) stipulated that the alternative method should be used only where *it has been customary*. It stated that the method should be used where ‘it has been customary in the past and is accepted in the country concerned both by taxation authorities and taxpayers generally there as being satisfactory’.<sup>1187</sup> However, where the method is not customary and the contracting states need to use it, this provision should be altered during the bilateral negotiation in order to make it clear.<sup>1188</sup> Notably, this is not the case in the CCCTB formulary apportionment.<sup>1189</sup>

It can be concluded that, in terms of Art7 (4), although the CCCTB-formulary apportionment involves the apportionment of the total profits of international enterprise, it cannot be considered as being customary, and its results are unlikely to be in accordance with the arm’s length principle contained in Art7(2). Therefore, recourse to the former Art.7 (4) of the OECD does not offer a solution in respect to reconciling formulary apportionment with the arm’s length principle.

One possible approach to eliminating tax treaty disputes, as a result of conflicting methods of allocation of the income of permanent establishments, is for CCCTB countries to *renegotiate their tax treaties with third countries*.<sup>1190</sup> The amendment of relevant third-country tax treaties, based on the OECD Model, would be a daunting task, especially in the light of the recent explicit embrace of the ‘Functionally Separate Entity approach’(FSE)<sup>1191</sup> by the OECD as outlined above.<sup>1192</sup> However, an elegant

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<sup>1187</sup> Commentary to Art 7(4) OECD MC 2008 paragraph 52.

<sup>1188</sup> *Ibid.*

<sup>1189</sup> Johanna Hey, ‘EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity’, (2008) New York University School of Law, Working Paper 02/08, p.50, available at <[centers.law.nyu.edu/jeanmonnet/papers/08/080201.pdf](http://centers.law.nyu.edu/jeanmonnet/papers/08/080201.pdf)>.

<sup>1190</sup> European Commission, The Territorial Scope of the CCCTB, (17/02/2006, CCCTB\WP\026\doc\en) paras. 34-37.

<sup>1191</sup> Under this approach, the profits attributable to a permanent establishment are those which would have been attained at arm’s length principle if it had been a separate entity engaged in the same activities

solution would be to provide a *special provision* on the use of the CCCTB-formulary apportionment in the relevant tax treaty between the CCCTB-Member State and third country.

### **5.5.2.2 Taxation of the EU-permanent establishment and the OECD Model non-discrimination clause**

The tax treatment of the EU-permanent establishment under the CCCTB system should be scrutinised from a non-discrimination provision perspective. Art. 24(3) of the OECD Model protects the permanent establishment of foreign enterprises *compared* to domestic enterprises conducting the same businesses activities.<sup>1193</sup> In terms of the requirements of comparability for purposes of equal treatment, the article clarifies that, for example, the domestic enterprise to which the permanent establishment is comparable has to have a legal structure that is similar to that of the foreign enterprise to which the permanent establishment belongs.<sup>1194</sup> In addition, as regards the comparability of the ‘same activities’, Art.24(3) states that regulated and unregulated activities cannot be considered as the ‘same activities’. For example, this provision does not require a permanent establishment which carries out a borrowing and lending as a part of its activities, but is not registered as a bank, to be taxed in the same manner as a domestic bank, as the permanent establishment does not conduct the same activities.<sup>1195</sup>

In the event that the above requirements are met, i.e. the permanent establishment of a third-country company is comparable to a CCCTB-resident enterprise and carrying out

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under the same conditions. There is, however, ‘relevant business activity’ approach (RBA), according to this approach, the profits attributable to the permanent establishment are limited to those profits that the entire international enterprise gains from the business activities in which the permanent establishment has part. This implies that losses incurred by the other parts of the international enterprise, which are engaged in the same activities of the permanent establishment, would decrease the profits that are attributable to the permanent establishment. If Art.7 (2) is interpreted in line with the latter approach, it could be of some assistance in solving the dispute between CCCTB-formulary apportionment and Art.7 of the OECD M. However, the FSE was adopted on the basis that is simpler and more administrable and more consistent with the arm’s length principle than RBA approach. Eventually, it explicitly expressed in the OECD commentary, see OECD, ‘Report on the Attribution of Profits to Permanent Establishments’ (Centre for Tax Policy and Administration 22 July 2010) .p.22, available at <[www.oecd.org/dataoecd/23/41/45689524.pdf](http://www.oecd.org/dataoecd/23/41/45689524.pdf)> accessed 21 December 2012.

<sup>1192</sup> *Ibid.*

<sup>1193</sup> It states in part :

‘The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities....’

<sup>1194</sup> Commentary to Art. 24(3) OECD Model, 2010, para.37.

<sup>1195</sup> *Ibid.*, para.38.

the same activities, it has to be included in the CCCTB system. Otherwise, the third-country company may complain that its permanent establishment located in the CCCTB Member State is taxed less favourably than another enterprise of the CCCTB-Member State whose profits are determined according to the CCCTB system.

However, the scope of the equal treatment principle under Art.24 (3) is limited to the comparison between the rules regulating the taxation of the *permanent establishment's activities themselves* and the rules that apply to similar activities carried out by an *independent resident enterprise*. In other words, its scope does not extend to the *rules governing consolidation issues*, i.e. the rules related to the relationship between an enterprise and other related enterprises. This is because the latter rules do not focus on the taxation of the enterprise's own activities which are similar to those of a permanent establishment; it is rather concerned with the taxation of the resident enterprise as a part of a consolidated group. Therefore, the principle of equal treatment is not relevant to the consolidation context.<sup>1196</sup> This implies that if the EU-permanent establishment is not consolidated in the CCCTB, while an enterprise resident in the same Member State is consolidated, this would not be considered as discriminatory, as the rules that regulate consolidation are outside the scope of Art.24 (3) of the OECD Model. However, as under the CCCTB system, the permanent establishment of a third-country company is treated in the same way as enterprises in their Member States of residence, i.e. its income is consolidated for consequent apportionment. Therefore, even if Art. 24(3) is interpreted in a way that extends its scope to include consolidation issues,<sup>1197</sup> the CCCTB system would not seem to violate any non-discrimination clause in double tax treaties with third countries

Moreover, the OECD commentary explicitly states that the application of the arm's length principle in respect to the dealings between the head office and the permanent establishment or vice versa is mandated by Art.7 (2) of the OECD Model. Therefore, treating the permanent establishment in this way cannot be considered as discriminatory under Art.24 (3) of the OECD Model.<sup>1198</sup> It can be submitted that insofar as the application of the arm's length principle in respect to the attribution of income to the

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<sup>1196</sup> Commentary to Art. 24(3) OECD Model, 2010, para.41.

<sup>1197</sup> Raul-Angelo Papotti, 'Treaty Non-Discrimination Clauses in Group Consolidation Situations', Intertax, Vol. 31, No.10 2003, pp.320-328 at 325.

<sup>1198</sup> Commentary to Art. 24(3) OECD Model, 2010, para.42.

permanent establishment does not violate Art.24 (3) of the OECD Model, applying CCCTB-formulary apportionment, to the permanent establishment, as an alternative, will not be in breach of this provision. In other words, leaving or including the permanent establishment in the CCCTB system has no relevance to Art.24 (3) of the OECD Model.

### **5.5.3 Compatibility in respect to tax treatment of inbound payments – taxation of residents**

As established earlier, income derived by residents in the CCCTB jurisdiction from third countries (foreign income) is included in the consolidated tax base and apportioned among the group members.<sup>1199</sup> Inclusion and apportionment of foreign sourced income would raise issues of compatibility with third-country tax treaties provisions, particularly in respect to the relief for foreign taxes regulated by articles equivalent to Arts. 23 A and 23 B of the OECD Model.

#### **5.5.3.1 Compatibility in respect of CCCTB methods for elimination of double taxation**

The CCCTB Directive provides a framework for avoidance of double taxation. This framework may be different from third-countries' OECD-based tax treaties and therefore could raise incompatibility. In principle, the CCCTB Directive provides for the combination of both the *exemptions with progression* method and the *ordinary credit* method. Specifically, the foreign income of a permanent establishment and its profit distributions are tax exempt, whereas tax paid on passive income (i.e. interest and royalties) in the source state is creditable in the residence Member State of the recipient.<sup>1200</sup>

As regards the OECD Model, the methods for elimination of double taxation are limited to two methods: exemption *with progression* and the *ordinary credit method*.<sup>1201</sup> The preference for one or other of these principles depends on the contracting states'

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<sup>1199</sup> See Chapter 3, section 3.3.4.

<sup>1200</sup> Chapter 4, section 4.2.1.

<sup>1201</sup> For the description of these methods see Commentary to Arts. 23 A and 23 B OECD Model 2010 paras. 12-27.



choice.<sup>1202</sup> Some contracting states may prefer the first one; some may have a preference for the other, and a combination of both methods may be used by some contracting states.<sup>1203</sup>

In the following discussion, the compatibility of the CCCTB rules with OECD-double taxation treaties will be examined in respect to double taxation relief for each item of foreign income.

### **5.5.3.2 Exempted income**

#### **5.5.3.2.1 Income of a foreign permanent establishment (Art.7 OECD Model)**

According to the OECD approach for taxing permanent establishments, where a permanent establishment is situated in a country other than the residence country of its head office, the income attributable to such a permanent establishment is taxed in the country where it is located (the source country), i.e. the head office country is precluded from taxing the income attributable to the permanent establishment in question (Art.7 (1) of the OECD Model). The income is attributed to the permanent establishment on the basis of the arm's length principle (Art.7 (2) of the OECD). If the residence country wishes to tax the income attributable to the permanent establishment, it has to eliminate double taxation, by operating either the credit or exemption method (Art.23 A and 23 B of the OECD).

Similarly, under the CCCTB system, the foreign permanent establishment is treated as a separate entity, so the income is attributed to it on an arm's length basis, and accordingly taxed therein.<sup>1204</sup> The income of the permanent establishment in question is exempted by the CCCTB Member State in which the head office resides.<sup>1205</sup> Therefore it can be said that the taxation of a foreign permanent establishment under the CCCTB system is in line with Art. 7 of the OECD. However, the above tax treatment would be problematic where the permanent establishment is under-taxed in the third country, as this would result in non-taxation. In this case, the switch-over clause will be of great assistance, as it is triggered in respect to low-taxed income of a foreign permanent

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<sup>1202</sup> Commentary to Arts. 23 A and 23 B OECD Model, 2010 para. 28-29.

<sup>1203</sup> *Ibid*, para. 31.

<sup>1204</sup> Art.78 (1) of the CCCTB Directive.

<sup>1205</sup> Art.11 (e) of the CCCTB Directive.

establishment.<sup>1206</sup> Therefore it can be concluded that the taxation of foreign permanent establishment income is consistent with Art.7 of the OECD.

#### **5.5.3.2.2 Dividends (Arts. 10(1) (2) and 23 (A) OECD Model**

Under Art. 10 OECD the taxing right of dividends is shared between the state of source and the state of residence. Dividends are subject to a limited taxation in the source state.<sup>1207</sup> The state of residence can choose not to tax the dividends (for example, under the sparing clause included in the relevant treaty),<sup>1208</sup> and to subject them to the exemption method. However, if the residence state prefers to use its taxing right on dividends, it cannot relieve double taxation by the exemption method, i.e. exemption with progression, since it would consequently give up fully its right to tax the income item concerned. Therefore, the application of the credit method to dividends income would seem to be a satisfactory solution. Moreover, under Art. 23 A (2), a residence state which generally applies the exemption method is allowed to apply to certain items of income the credit method rather than the exemption method as it is subject to a limited taxation in the source state. Among these items of income mentioned in the subsection is dividends. Therefore in this case, Art. 23 A (2) provides a credit for the limited tax paid on dividends in the source state against tax payable in the residence state.

The combined outcome of the application of Art.10 (1) and (2) and Art. 23 A (2) is that when the residence state of a parent company is allowed to tax the subsidiary's dividends arising in the source state, in doing so, a credit at the reduced rate applicable in Art. 10 (2) *must be granted* for the elimination of double taxation.<sup>1209</sup>

Having said that the CCCTB regime applies the combination approach, the exemption method is the main method and the credit method is applicable only to specific items of income, but the CCCTB regime taxes dividend distributions of a company resident in a third country and applies the exemption method to eliminate double taxation. Therefore, the taxation of dividends received from a third country is *contrary* to the OECD Model *taxation of dividends* because under the OECD Model dividends are among the income

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<sup>1206</sup> Art.73 of the CCCTB Directive.

<sup>1207</sup> For more on dividends taxation see Hugh J. Ault and Jacques Sasseville, 'Taxation and Non-discrimination: A Reconsideration', World Tax Journal, Vol. 2, No. 2, 2010, pp.101-125, at 103.

<sup>1208</sup> Commentary to Art. 23B OECD Model, 2010 paras. 72-78.

<sup>1209</sup> Commentary to Arts. 23 A and 23 B OECD Model, 2010 para. 49.

items to which the credit method is applicable as long as it is taxable in the residence state.<sup>1210</sup>

As a result, if for example a CCCTB Member State is required – according to its tax treaty with third country – to give a tax credit to the third country’s subsidiary for the *reduced* withholding tax imposed on the dividends therein, it then has to switch to the CCCTB exemption method, which will open the opportunity to the third country to object to the breach of the international public law obligation stemming from its treaty with the CCCTB Member State. Thus, the relevant tax treaties between the CCCTB Member states and third countries *will need to be renegotiated in the long run*. In practice, switching from credit to exemption in respect to taxation of dividends would not raise objections by third countries because they are in the position of a source state.<sup>1211</sup>

### **5.5.3.3 Credit Method**

#### **5.5.3.3.1 Interest, royalties and other income taxed in third countries**

Under Art. 11 of the OECD, the source state is entitled to impose withholding tax on interest income up to a limited percentage. Moreover, the residence state of the recipient is allowed to tax such income. In this case, one possibility for eliminating double taxation is for the residence state to credit the limited tax levied on interest in the source state. This possibility is outlined in Art. 23 A OECD under which the residence state can adopt the combination of both methods to eliminate double taxation, i.e. the exemption method generally and the credit method for interest and dividends in particular because these items of income are subject to limited taxation in the source state.<sup>1212</sup> It seems that the CCCTB Directive has followed this scenario to eliminate double taxation in respect of interest. Therefore, if the tax treaty between the third country and the CCCTB Member State concerned follow the same scenario to eliminate

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<sup>1210</sup> In the context of the HST, it has been suggested some intermediate solutions to get around this problem, but these alternatives solutions are not consistent with the CCCTB policy of worldwide taxation and a common tax system, for example if one of them is transposed into the CCCTB situation would be as following; foreign dividends exempted under the CCCTB should be excluded from the CCCTB regime and then to be added to the profits apportioned according to the Formulary apportionment in the CCCTB, see Sven Olof Lodin, Malcolm Gammie, *Home State taxation* (IBFD 2001), pp.87,88.

<sup>1211</sup> Philip Baker, Loanna Mitroyanni, ‘The CCCTB rules and Tax Treaties’ in in Michael Lang et al. (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p. 640.

<sup>1212</sup> Commentary to Arts. 23 A and 23 B OECD Model, 2010 preliminary remarks, para. 31.

double taxation on interest, then no conflict would arise, i.e. the interest income would still be granted a credit against the tax imposed on the CCCTB Member State, hence it would not contradict the CCCTB Directive.

However, a conflict would arise in two situations: *firstly*, if the tax treaty between the third country and the CCCTB-Member State applies the full credit method contrary to the CCCTB ordinary credit method. The CCCTB Directive provides a solution for such conflict, stating that the ordinary credit method would apply to the income of interest received from a third country unless the tax treaty between the third country and the CCCTB Member State states otherwise.<sup>1213</sup> *Secondly*, if for example under the provisions of the current tax treaty between the third country and the CCCTB-Member State, the latter is required to exempt interest derived from third country, a conflict would arise with the CCCTB rules. *Therefore, such tax treaty would need to be adjusted.* For royalties, if the 0% rate of the OECD Model is applicable in the current tax treaties with third countries, then there would not be any incompatibility with such treaties.

#### **5.5.3.3.2 The apportionment of credit granted for tax paid in third countries**

As established earlier, the foreign tax credit, which is given only by the residence Member State of the recipient, will be shared among the members of a group in different CCCTB-Member States according to the CCCTB-formulary apportionment.<sup>1214</sup> However, the apportionment of foreign tax credit may not be compatible with third-country tax treaties.

If the foreign tax imposed by the third country (as a source state) on passive income is fully credited in the residence Member State of a group member, the apportionment of foreign tax credit amongst the other group members located in different Member States does not seem to cause third countries to raise objections.<sup>1215</sup> However, such third countries will be concerned when the income that benefits from reduced withholding taxes (and accordingly less relief by credit is paid by the residence state) on the basis of its bilateral tax treaty with the residence Member State of the group member is flowing

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<sup>1213</sup> Art. 76 (5) of the CCCTB Directive.

<sup>1214</sup> Art. 76 (2) of the CCCTB Directive.

<sup>1215</sup> Philip Baker, Loanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang et al. (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p. 641.

in part to other group members in other Member States with which the third country has no tax treaties or has tax treaties that do not provide for such reduced withholding taxes.<sup>1216</sup> Therefore, a possible solution for the above problem is to develop a common EU tax treaty based on a common credit method. According to such a solution, the consolidated group's members in several different Member States can be put on a par with third countries.

#### **5.5.4 Tax-sparing clause and the CCCTB system**

Another important potential conflict between the CCCTB rules on double taxation relief, especially in relation to the credit method and current third-country tax treaties, touches upon the tax-sparing clause. Tax-sparing mechanisms appear in several tax treaties,<sup>1217</sup> but the CCCTB Directive does not contain such a mechanism. The next section examines how this incompatibility may be solved, but first it is essential to define the tax-sparing mechanism.

##### **5.5.4.1 What is a 'tax-sparing clause?'**

Economic growth is a prerequisite for a country's development. In this respect, FDI, *inter alia*, is a crucial constituent which gives a country the opportunity to grow its economy and consequently to develop. Thus, all countries, but emerging or developing countries in particular, endeavour to attract FDI. In doing so, developing countries often offer tax incentives in the form of a tax rate reduction, a tax holiday or in some cases, the exemption of certain types of income from tax.<sup>1218</sup>

However, the tax system of the foreign investor's home country may reduce or in some cases completely remove the fiscal effect of tax incentives which are created in the host

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<sup>1216</sup> Philip Baker, Loanna Mitroyanni, 'The CCCTB rules and Tax Treaties' in Michael Lang et al. (Eds.) *Common Consolidated Corporate Tax Base* (Linde, 2008), p. 641.

<sup>1217</sup> Morvan Meirelles, 'Tax Sparing in Tax Treaties: The Future and the Effect on EC Law', *European Taxation*, May 2009, pp.263-273, at 265.

<sup>1218</sup> Usually developing countries offer these tax incentives as a remedy for their moderate or poor local economic conditions, which make them less attractive and discourage FDI, or the difficulty of obtaining factors' production, inhospitable legal and regulatory environment, and the relatively undeveloped state of public infrastructures such as port facilities and telecommunications. Thus, tax incentives would place developing countries in the same level playing field of other developed countries, see James R. Hines Jr., 'Tax Sparing and Direct Investment in Developing Countries' (1998) Working Paper 6728, Cambridge, MA: National Bureau of Economic Research, pp.2,3, Available at <[www.nber.org/chapters/c10719.pdf](http://www.nber.org/chapters/c10719.pdf)> accessed 10 November 1012.

country. Where the home state of a foreign investor operates a residence-based taxation system, the distributed profits earned on FDI are subject to tax in that home state. To avoid double taxation, the home state would have to either exempt the foreign income or provide tax credits for tax already paid in the host country. When the home country of the foreign investor applies the credit method, it will first tax the income that benefited from the tax incentive and then allow a credit for the tax that was actually paid in the host country. This means that the fiscal benefit of tax incentives that was granted in the host country was in vain and only a windfall gain to the home country's treasury.<sup>1219</sup> Similarly, if the home state applies an exemption method but the application of that method is subject to a certain level of taxation by the host country, i.e. it is switched to a credit method, granting tax incentives in the host country would result in denying the application of the exemption method in the home country of the foreign investor.<sup>1220</sup>

In reaction to these results, a '*tax-sparing clause*' was introduced in bilateral tax treaties.<sup>1221</sup> Under this clause, the home country of the investor (that is, the developed country) "spares" the tax that it would normally impose on the low-taxed or untaxed income earned by its resident in the host country (that is, the developing country). In doing so, it grants foreign tax credits equal to, or maybe greater than, the tax that would otherwise have been exigible in the host country. It also ensures that the conditions for applying the exemption method would take into account the tax incentives provided in the host country.<sup>1222</sup> Therefore, a '*tax-sparing clause*' is intended to sustain the effectiveness of tax incentives, which are used by the developing country to attract FDI, by ensuring that they are not nullified by the developed country's tax system.

Although the current and previous versions of the OECD Model have not contained an explicit tax-sparing provision, nevertheless, the tax-sparing concept has been recognised

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<sup>1219</sup> Commentary to Art. 23 B (1) OECD Model, 2010 para.72.

<sup>1220</sup> *Ibid.*

<sup>1221</sup> Although Tax sparing clause sounds as an esoteric concept, it is, however, a relatively an old principle, its origin dates back to 1953, when a British royal commission suggested that the United Kingdom should adopt tax sparing as an aid for its investment abroad. The British Parliament initially rejected this suggestion in 1957. However, in 1961, this legislation was enacted and enabled the UK government to grant tax sparing to developing countries on a bilateral basis, OECD, Tax Sparing: A Reconsideration (Paris: OECD, 1998), p.15.

<sup>1222</sup> Deborah Toaze, 'Tax Sparing: Good Intentions, Unintended Results', Canadian Tax Journal, Vol. 49, No. 4, 2001, pp. 879-924, at 881.

and supported in the commentary of the OECD Model.<sup>1223</sup> Today, almost all OECD members have included tax-sparing provisions in the majority of their tax treaties, except the United States.<sup>1224</sup> The tax-sparing concept is justified by the OECD on the basis that it is a constituent of a whole foreign aid policy that is intended to promote economic growth in developing countries. Moreover, it is considered to allow the OECD member to expand their tax treaty network with developing countries and decrease withholding tax rates. Additionally, it secures the competitive position of their investors abroad in relation to the other investors whose home countries provide a tax sparing clause.<sup>1225</sup>

Similarly, EU-Member States, in their tax treaties with developing countries, use tax-sparing mechanisms to safeguard the fiscal benefits of tax incentives granted by those countries. The issue of the compatibility between the CCCTB rules and tax treaties raises the question of whether CCCTB-Member States which adopted tax-sparing mechanisms in their tax treaties with developing countries would be able to continue applying these under the CCCTB system. If so, other CCCTB Member States who did not necessarily have a tax-sparing clause in their tax treaty might be affected in respect of their share of the common tax base. Thus, this issue will be examined as follows.

*In the short run*, as demonstrated earlier, the existing tax treaties between CCCTB-Member States and third countries (whether developed or developing ones) would override CCCTB rules. This implies that those Member States who incorporated a tax-sparing clause in their tax treaties would be able to continue applying it under the CCCTB scheme. In this respect, however, what needs to be examined is whether the application of the tax-sparing clause is principally relevant,<sup>1226</sup> in the light of the CCCTB tax treatment of the foreign income. If it is relevant, the extent to which it will contradict the CCCTB rules in respect of the foreign income taxation needs to be addressed.

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<sup>1223</sup> See the published model of the OECD and their amendments: *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963); (Paris: OECD, 1977); and *Model Tax Convention on Income and on Capital* (Paris: OECD, 1992) and its amendment in 1994, 1997, 2000, 2008 and Commentary to Art 23 B (1) OECD Model 2010 paras. 72-78.

<sup>1224</sup> For a lengthy debate over the tax sparing provision in the United States see William J. Martin, 'Treaty Tax-Sparing Credits', *Tax Management International Journal*, Vol 27, No. 9, 1998, pp.444-465.

<sup>1225</sup> OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998), p.19.

<sup>1226</sup> The application of tax-sparing clause is not relevant, for example, where the residence country of the foreign investor unconditionally exempt the foreign income gained on the FDI in the source country.

As regards the relevance of the tax-sparing clause under the CCCTB system, certain types of foreign-source income – for example interest and royalties which are earned by CCCTB residents – are granted a credit for the actual tax paid abroad, irrespective of the *taxation level* in the source country.<sup>1227</sup> Thus, if the foreign income is accorded any tax reduction or incentive, the benefit of such incentives would be immediately captured by the CCCTB-Member State. Therefore, the application of tax-sparing would be relevant here, particularly where the income is sourced in a developing country.

On the other hand, other forms of foreign income, such as dividends, enjoy the exemption treatment, and to this extent it can be thought that a ‘tax-sparing clause’ has no applicability here, as the tax incentive granted by the source country (that is, a developing one) would not be nullified under unconditional exemption treatment. However, the tax exemption in the CCCTB is contingent on the condition that the source country is not a *low-tax* jurisdiction, regardless of whether the country is a developing country or not; otherwise the income in question would be subject to the tax credit method by reason of the *switch-over clause* as provided in the CCCTB Directive. Consequently, the tax-sparing clause application is relevant here as well.

Thus, pursuant to the CCCTB’s treatment of the foreign income – either the exemption or the credit method – which is sourced in a developing country with which a CCCTB Member State has a tax treaty, the tax-sparing would be of vital relevance. Consequently, the respective Member State should persist in applying it, so as to respect its tax treaty with a third country, and to avoid nullifying the tax incentives of the developing third country. In doing so, as regards the tax credited income, the CCCTB-Member State has to grant foreign tax credits equal to the tax that would otherwise have been exigible in the developing third country. In respect to the exempted income, the CCCTB-Member State has to exempt the respective income unconditionally. In other words, it has to cease applying the switch-over clause<sup>1228</sup> if the income is low-taxed by virtue of granting tax incentives in the developing third-country with which it has a tax treaty that contains a tax-sparing clause. Thus, the tax-sparing provision included in the existing tax treaties with third countries contravenes the CCCTB’s switch-over clause.

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<sup>1227</sup> Art. 76 of the CCCTB Directive.

<sup>1228</sup> Art. 73 of the CCCTB Directive.



Moreover, if the CCCTB-Member States which incorporated a tax-sparing clause in their tax treaties with developing third countries continue to apply it under the CCCTB scheme, it will be problematic *vis-à-vis* CCCTB-Member States who did not have a tax-sparing clause in their tax treaties, since the CCCTB entails the appointment of income and credits. Thus, those ‘phantom’ credits that correspond to a certain ‘tax-sparing’ policy of some CCCTB-Member States would reduce taxes in the CCCTB-Member States that did not necessarily share such views or obtain any benefits behind this policy.

One possibility in solving the above problems, especially *in the long run*, is for the CCCTB-Member States to renegotiate their tax treaties with developing third-centuries. Such renegotiation, however, will require a common policy in respect to a tax-sparing clause. This common policy could be for all CCCTB-Member States to cease applying a tax-sparing clause in relation to third countries. Alternatively, leeway could be given to the Member States in this respect. However, in cases where some CCCTB-Member States decide not to apply it, they should recognise the tax-sparing application by other CCCTB-Member States and agree to share the fictitious credits.

Embracing one of these alternatives is mainly contingent on certain arguments in favour of or against tax-sparing mechanisms. Apart from the influence of political will, the signatories of a tax-sparing provision over the last five decades have experienced conflicting stances in respect to its effectiveness in promoting economic development in developing countries.<sup>1229</sup> On the one hand, it has been put forward that a tax-sparing provision is conducive to positive economic consequences. It is submitted that tax-sparing significantly influences the FDI location, it attracts FDI and affects the policy of developing countries, i.e. where a developing country enters into a tax-sparing treaty, it is more encouraged to reduce tax rates and to grant tax incentives to foreign investors in the country with which the tax-sparing treaty is concluded.<sup>1230</sup> Moreover, the above

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<sup>1229</sup> For an excellent study on the tax sparing provision’s debate see Brooks, Kim, ‘Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?’ ,Queen's Law Journal, Vol. 34, No. 2, Spring 2009,pp.505-564.

<sup>1230</sup> James R. Hines Jr., ‘Tax Sparing and Direct Investment in Developing Countries’, (1998) Working Paper 6728, Cambridge, MA: National Bureau of Economic Research, available at <[www.nber.org/chapters/c10719.pdf](http://www.nber.org/chapters/c10719.pdf)>, in this study the structure of both the US and Japan was compared over the time period of 1990, the study found that a bigger portion of the Japanese companies’ investment

results were confirmed by another study.<sup>1231</sup> First, the study confirmed that the relationship between the tax-sparing provision and FDI exists; it shows that FDI flows from a developed country into tax-sparing countries were nearly three times higher than FDI flows into non-tax-sparing countries. It concluded that the developing countries' taxation policy on granting various tax incentives and the tax-sparing granted by developed countries significantly influence the location of FDI in favour of the developing countries.<sup>1232</sup>

On the other hand, the effectiveness of tax incentives in attracting incremental foreign investment was questioned by some scholars,<sup>1233</sup> as the associated revenue cost to the developing country's incentives is expected to be quite high.<sup>1234</sup> It has been claimed that tax incentives *per se* are not the decisive component in attracting FDI. There are, however, other factors, among which tax incentives are the only equivalent one. These factors consist of political and economic stability, stable and transparent legal and regulatory frameworks, adequate support institutions and facilities, and the availability of a tax system that is in line with international norms.<sup>1235</sup>

Moreover, the OECD's position in respect to the tax-sparing mechanism has changed recently. To be precise, a paper published in 1998 by the OECD concluded that the tax-sparing mechanism is not necessarily an effective means of promoting economic development in developing countries.<sup>1236</sup> It added that this mechanism is in practice

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was directed to countries with which Japan has signed a tax sparing treaties. In contrast, a lower portion the US companies' investments were located in these countries as the US has not signed tax sparing treaties with them.

<sup>1231</sup> Celine Azemar, Rodolphe Desbordes, Jean-Louis Mucchielli, 'Do tax Sparing Agreements Contribute to the Attraction of FDI in Developing Countries?' , *International Taxation and Public Finance*, Vol 14, 2007, pp.543-262, at 558.

<sup>1232</sup> *Ibid.*

<sup>1233</sup> Morvan Meirelles, 'Tax Sparing in Tax Treaties: The Future and the Effect on EC Law', *European Taxation*, May 2009, pp.263-273 at 265.

<sup>1234</sup> Brooks, Kim, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?' *Queen's Law Journal*, Vol. 34, No. 2, 2009, pp.505-564, at 38, available at <SSRN: <http://ssrn.com/abstract=1434069>> accessed 15 November 2012.

<sup>1235</sup> It is suggested that the best way for the host country to encourage FDI is to depend on the all factors see Vita Tanzi and Howell H. Zee, 'Tax Policy for Emerging Markets: Developing Countries'(2000) Working paper WP/00/35, International Monetary Fund IMF, p.24, available at <[www.imf.org/external/pubs/ft/wp/2000/wp0035.pdf](http://www.imf.org/external/pubs/ft/wp/2000/wp0035.pdf)> accessed 15 December 2012.

<sup>1236</sup> OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998), p.12; *Commentary to Art 23 B (1) OECD Model*, 2010 para. 77.

very vulnerable to the taxpayer's manipulation.<sup>1237</sup> The value of the tax-sparing clause has become doubtful due to the accelerating integration of the domestic economies, which in turn increase the geographical mobility of the national tax bases. Consequently, any ill-designed tax-sparing provision will result in tax erosion of the other countries' tax bases.<sup>1238</sup> In particular, it is submitted that among the most serious abuse resulting from tax-sparing is the erosion of the tax revenue of the developing countries which they badly need.<sup>1239</sup>

Accordingly, the OECD concluded that its members should not necessarily refrain from negotiating or implementing tax-sparing provisions in their tax treaties with developing countries. However, it does recommend that tax-sparing should be considered only in circumstances where the economic level of the country to which tax-sparing is granted is considerably below that of the OECD country.<sup>1240</sup> In addition, the OECD recommends that objective economic criteria should be employed to determine the countries that should be eligible for tax-sparing.<sup>1241</sup>

From the perspective of the EU, the arguments against tax-sparing are based not only on its vulnerability to tax avoidance,<sup>1242</sup> but also on its incompatibility with EC law. The tax-sparing benefits are restricted to those residents of a Member State who invest in a country with which that Member State has a tax-sparing treaty, but other residents of the same Member State investing in a non-tax-sparing treaty do not benefit from such a mechanism.<sup>1243</sup> Thus, the tax-sparing clause raises a discriminatory issue, as EU

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<sup>1237</sup> Commentary to Art. 23 B (1) OECD Model, 2010 para. 76; for examples on clarifying the tax avoidance in light of tax sparing clause see Morvan Meirelles, 'Tax Sparing in Tax Treaties: The Future and the Effect on EC Law', *European Taxation*, May 2009, pp.263-273 at 264.

<sup>1238</sup> Commentary to Art. 23 B (1) OECD Model, 2010 para. 78.

<sup>1239</sup> Brooks, Kim, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?' *Queen's Law Journal*, Vol. 34, No. 2, 2009, pp.505-564, at 564, available at <SSRN: <http://ssrn.com/abstract=1434069>>.

<sup>1240</sup> Commentary to Art. 23 B (1) OECD Model, 2010 para, 78.1.

<sup>1241</sup> *Ibid.*

<sup>1242</sup> For example tax-sparing provision can be abused in the situation involving three Countries A, B and C, in which countries A and B are Member States, C is a third country. There are tax treaties between the three countries but only in the B-C tax treaty is a tax sparing provision. Resident in country A can benefit from spared credits on the recipient dividends from sources in country C by contributing the income to a permanent establishment in country B. In this case, the B country would extend to permanent establishment in question the same tax treatment, and consequently the benefits, it grants to residents of country B under the B-C tax treaty including tax sparing clause.

<sup>1243</sup> Hans Van Den Hurk and Jasper Korving, 'The "D" Case against the Netherlands and the ECJ's decision- Is There Still a Future for MFN Treatment', *Bulletin for International Fiscal Documentation*, August 2006, pp. 365-373 at 372.

nationals, who are in an objectively comparable situation, are treated differently. In this context, the tax-sparing mechanism puts the residents who invest domestically in a competitive position that is disadvantageous compared to resident investing overseas.<sup>1244</sup>

Moreover, it is argued that if the fictitious credits granted by Member States through the operation of tax-sparing provisions are regarded as an indirect aid to the developing third countries, the tax-sparing mechanism avoids the paternalism inherent in direct grant programs for foreign aid that is forbidden by EC law.<sup>1245</sup> However, it is submitted that the tax-sparing mechanism can be considered as an illegal State Aid by Art. 107 of TFEU<sup>1246</sup> where the following conditions are met: if the tax-sparing provision secures a tax prerogative to a certain group of persons through a Member State's own resources; if it distorts or threatens to distort competition between Member States of the EU; and if it is not consistent with the scale of the tax system of the Member State in which it is adopted. Consequently, if the tax-sparing mechanism distorts the competition, the foreign tax credit policy of the Member State granting the tax-sparing credit becomes to some extent dictated by the third country's policies.<sup>1247</sup>

It would appear that the above pitfalls of the tax-sparing provision would continue to exist under the CCCTB system. It should be stressed that the application of a tax-sparing provision among CCCTB-Member States themselves will not be relevant any more, as consolidation eliminates withholding taxes and credit relief between members of a consolidated group. However, the application of a tax sparing provision in relation to third countries would still raise the above difficulties. Moreover, it would be even more problematic if not all CCCTB-Member States apply a tax-sparing clause. The CCCTB system entails the share of income and foreign tax credit, under the tax-sparing clause the sharing of the 'phantom' credit between tax-sparing CCCTB-Member States

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<sup>1244</sup> Morvan Meirelles, 'Tax Sparing in Tax Treaties: The Future and the Effect on EC Law', *European Taxation*, May 2009, p.270.

<sup>1245</sup> Brooks, Kim, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?' *Queen's Law Journal*, Vol. 34, No. 2, Spring 2009, p. 549.

<sup>1246</sup> Art. 107 of TFEU reads as follows:

'Save as otherwise provided in the Treaties any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.'

<sup>1247</sup> Morvan Meirelles, 'Tax Sparing in Tax Treaties: The Future and the Effect on EC Law', *European Taxation*, May 2009, pp.263-273 at 270.

and non-tax-sparing CCCTB-Member States would not be satisfactory to the latter. On the other hand, if all Member States abandon the application of the tax-sparing clause it would not be a realistic solution at this stage because despite all the arguments against tax-sparing, many countries still include a tax-sparing clause in their treaties. Furthermore, this possibility would require a quest for an alternative policy to support developing countries in strengthening their tax bases and in raising tax revenues, which is critical for these countries. The alternative could be for tax-sparing to be replaced by a direct aid programme including ‘direct transfer of capital, market liberalisation and low interest rate funding’.<sup>1248</sup>

Therefore, one possible solution for the above tax-sparing problems is for the CCCTB-Member States which already have a tax-sparing clause in their tax treaty with a third country, to continue applying it towards such country. However, in this case, it can be proposed that other non-sparing-clause CCCTB-Member States should share the ‘fictitious’ credit provided by one CCCTB Member State. This solution can be upheld by including a provision in the CCCTB Directive on the apportionment of the ‘fictitious’ credits. The apportionment can be carried out on the basis of formula apportionment as in the case of actual credit apportionment. In optimising the outcome of this solution, it can be proposed that the CCCTB should properly redesign or establish a common tax-sparing provision to be applied by all CCCTB-Member States. In this design, what needs to be considered is that it should achieve its purposes while minimizing its unfairness and limiting tax abuse.<sup>1249</sup> In this context, the criteria proposed in the OECD report, on the design of a tax-sparing provision, could be of some assistance.

One criterion concerns the types of income covered by the tax-sparing clause; namely, that tax-sparing provisions should only be employed to protect incentives that promote the development of the relevant developing country.<sup>1250</sup> The OECD recommended that tax-sparing should not cover passive income. Nonetheless, it is argued that this is too wide a restriction, as in most cases extending tax-sparing to passive income such as

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<sup>1248</sup> Morvan Meirelles, ‘Tax Sparing in Tax Treaties: The Future and the Effect on EC Law’, *European Taxation*, May 2009, pp.263-273 at 272.

<sup>1249</sup> Brooks, Kim, ‘Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?’ *Queen’s Law Journal*, Vol. 34, No. 2, 2009, pp.505-564, at 559, available at <SSRN: <http://ssrn.com/abstract=1434069>> accessed 1 December 2012.

<sup>1250</sup> *Ibid.*

royalty and interest is unlikely to raise tax abuse.<sup>1251</sup> Moreover, the scope of tax-sparing should be extended to business income where such business is necessary for the development of the developing country.<sup>1252</sup>

Another criterion is the taxpayer's eligibility for a tax-sparing clause. A tax-sparing provision, in practice, applies to corporate taxpayers rather than individual taxpayers. It is thought that this would decrease the abuse opportunities in such a provision; it is also simple from an auditing perspective. Moreover, it mostly refers to the specific incentive rules to which it applies. However, other tax treaties provide a more general tax-sparing provision which allows investors to benefit from tax sparing for a wide range of tax incentive legislation.<sup>1253</sup> The tax-sparing clause could be confined to cover only specific incentive provision provided by the developing country rather than a general tax-sparing provision; this could limit the abuse of tax-sparing.<sup>1254</sup>

### **5.5.5 Compatibility of the CCCTB's anti-abuse rules with double tax treaties**

This section examines the interaction between the CCCTB's anti-abuse rules and third-country double tax treaties. These anti-avoidance rules include the switch-over clause, CFC rules and thin capitalisation legislation.

#### **5.5.5.1 The switch-over clause and the violation of third-country double tax conventions**

As demonstrated in the previous chapter, amongst the anti-avoidance provisions provided in the CCCTB Directive is the switch-over clause from the exemption method

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<sup>1251</sup> OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998), p.35.

<sup>1252</sup> Brooks, Kim, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries or an Unnecessary Revenue Sacrifice?' *Queen's Law Journal*, Vol. 34, No. 2, 2009, pp.505-564, at 559, available at <SSRN: <http://ssrn.com/abstract=1434069>>.

<sup>1253</sup> OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998), p.35.

<sup>1254</sup> More criteria that can be used in the design of the tax sparing provision in the CCCTB are; limiting the 'fictitious' credit relief to a certain maximum tax rate applicable in the developing country, limiting the time for the application of tax sparing provision, including a specific anti-abuse clause to tax sparing and stipulating the exchange of information in respect to tax sparing's operation. These criteria could be of a great assistance for the CCCTB in designing tax sparing clause in relation to third countries see OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998), p.35.

to the credit one in respect to specific items of income which are low-taxed in third countries.<sup>1255</sup>

The switch-over clause is a common mechanism in the context of international tax law in respect to certain types of income. It is included in the OECD Model in the context of the application of methods for elimination of double taxation,<sup>1256</sup> in the provision that deals with the exemption method.<sup>1257</sup> Under such provision, the residence state is allowed to shift from the exemption method into the ordinary credit method when the resident taxpayer is the beneficial owner of items of income whose taxing right is ruled by the partial distributive provisions of Art. 10 on dividends and Art. 11 on interest income.<sup>1258</sup>

A justification for the switch-over clause is that the right to tax the items of dividends and interest income is shared between the residence state and the source one. This means that such provisions are incomplete or partial distributive rules because the term ‘may be taxed’ is used in such a proviso.<sup>1259</sup> Therefore, the residence state is not obliged to tax such items of income. In this case, if the exemption method is applied by the state of residence to eliminate the double taxation, this would imply that it will fully give up its tax right to tax the income concerned. In this context, the application of the credit method seems to be a satisfactory solution.<sup>1260</sup> Thus, the switch-over clause works as a safeguarding mechanism, i.e. a method to protect the domestic tax base.

Moreover, it is provided that the residence state, which applies the exemption method, can switch to the credit method in respect to items of income that benefit from preferential tax treatment in the source country by virtue of a tax measure that has been provided by that country after the treaty entered into force, but this case has to be

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<sup>1255</sup> Art. 73 of the CCCTB Directive.

<sup>1256</sup> See Arts. 23 A, and 23 B of the OECD Model.

<sup>1257</sup> See Art. 23 A (2) of the OECD Model:

‘Where a resident of a Contracting State derives items of income which, in accordance with the provision of Articles 10 and 11, may be taxed in the other Contracting State, the first mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from the other State’.

<sup>1258</sup> Commentary to Art. 23 A (2) of the OECD Model, 2010, para. 31.

<sup>1259</sup> Art. 10 and 11 of the OECD Model.

<sup>1260</sup> Commentary to Art. 23 A (2) of the OECD Model, 2010, para. 47.

explicitly stated in the relevant convention.<sup>1261</sup> However, unlike the CCCTB Directive, the switch-over clause in the OECD Model can be considered as a general anti-abuse mechanism<sup>1262</sup> because it does not target any specific abusive situations.<sup>1263</sup>

Despite the fact that the switch-over concept is principally included in the international tax law as in the OECD Model, the issue at stake would be whether the CCCTB's switch-over clause violates double tax treaties concluded between Member States and third countries. This issue arises because the main objective of double tax treaties is the elimination of juridical double taxation and not the prevention of economic double taxation.<sup>1264</sup> In this regard, under the assumption that bilateral tax treaties between CCCTB-Member States and third countries strictly follow the OECD Model, it can be said that the switch-over clause *per se* does not constitute a violation of such conventions, unless the relevant tax treaty does not include the switch-over clause. However, the targeted abusive situations and the items of income covered by the switch-over clause in the CCCTB are not the same as in the OECD. In the OECD Model there is no switch over-clause regarding the foreign source income attributable to foreign permanent establishment and capital gains; it is only concerned with dividends and interest income. Moreover, the abusive situations such as the prevalence of a special tax regime or a low tax rate in third countries are not specified by the OECD Model. Therefore, *renegotiation of the tax treaties between Member States taking part in the CCCTB and third countries would still be needed* in order to accommodate the CCCTB switch-over mechanism.

#### **5.5.5.2 Compatibility of the CCCTB's CFC rules with double tax treaties**

The CCCTB's CFC rules are an anti-avoidance mechanism which stipulates that resident shareholders of foreign companies will be taxed on a share of the undistributed income of these companies. It has been used by many OECD members as an important tool in fighting harmful tax practices, as demonstrated in the previous chapter.<sup>1265</sup>

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<sup>1261</sup> Michael Lang, et al, *Tax Treaties: building bridge between law and economics*, (2010, IBFD), p. 196.

<sup>1262</sup> *Ibid.*

<sup>1263</sup> Commentary to Article 23 A (2) of the OECD Model 2010, Para 31(1).

<sup>1264</sup> Dennis Weber /Antonio Russo, 'The 'Switch-over' Clause' in Michael Lang et al. (eds.) *Common Consolidated Corporate Tax Base* (Linde 2008), p.766.

<sup>1265</sup> OECD, *Controlled Foreign Company Legislation* (1996), p.97; see also European Commission, 'The application of Anti-abuse Measures in the Area of Direct Taxation- within the EU and in relation to Third Countries, COM(2007)785 final.



However, from an international perspective, the question arises as to whether the CCCTB's CFC rules are compatible with the tax treaties.

In fact, the applicability of domestic CFC rules to tax treaties relations is complex and unsettled in most cases. The courts of different states have reached contrary decisions on the compatibility of CFC rules with tax treaties. In addition, the on-going literature is not clear and goes in a circular argument in this respect. The OECD position, which admits the compatibility of CFC rules with tax treaties, is not convincing for many scholars. An attempt will be made here to identify the main problems that could prevent the application of CFC rules in tax treaty situations.

#### **5.5.5.2.1 The OECD Model position**

The consistency of the CFC rules with double tax treaties<sup>1266</sup> is *implicitly* referred to in the commentary of the OECD Model<sup>1267</sup> tax convention for the first time in 1992.<sup>1268</sup> According to this reference, the CFC rules do not contradict double tax treaties as they are part of the domestic rules for determining the tax liability which fall under the ambit of the national tax law.<sup>1269</sup> Since these rules are not dealt with in the double tax treaties, they are not in conflict with them. The OECD's standpoint implies that the CFC rules do not need to be expressly mentioned in the tax treaty, i.e. the so-called 'substance-over-form' principle prevails.<sup>1270</sup>

From 2003 until now, the OECD has explicitly stated its position, that is, the CFC legislations are not in conflict with the double tax treaties, they are applicable in any case, and it is not necessary for them to be explicitly authorised in the tax treaty provisions: again the concept of 'substance-over-form' is applicable.<sup>1271</sup> The argument

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<sup>1266</sup> This issue were first addressed by the 1977 OECD in commentary to article 1, para.7. It was noted that the exploitation the differences of various countries' tax systems in respect to tax level and tax advantages is possible. Thus, the concerned countries can adopt provisions in their national law in order to prevent such manipulation. The application of these domestic provisions can be preserved into double tax treaties of the concerned countries.

<sup>1267</sup> The amendment to the commentary of the 1992 OECD was based on two reports titled 'double taxation convention and the use of base companies', and 'double taxation conventions and the use of conduit companies' see OECD, *International Tax Avoidance and Evasion: Four related studies*, 1987.

<sup>1268</sup> Commentary to Art 1 OECD Model, 1992, para.22.

<sup>1269</sup> For general discussion on the interaction between tax treaties and anti-abuse rules see Brian J. Arnold and Stef van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-abuse Measures', in Guglielmo Maisto (ed.) *Tax Treaties and Domestic Law* (IBFD 2006), pp.81-120 at 85.

<sup>1270</sup> Commentary to Art. 1 OECD Model, 1992 para. 23.

<sup>1271</sup> Commentary to Art. 1 OECD Model, 2010 para. 23, it reads as:

brought forward in favour of the above position is that anti-avoidance measures, in particular the CFC rules, are adopted by the States in their national tax laws in order to maintain the equity and neutrality of national tax laws in an international environment; however, counteracting measures of this type should be used for this purpose only,<sup>1272</sup> and the CFC rules should not be applicable where the taxation in the residence country of the foreign company is comparable to the taxation of the shareholder's state of residence.<sup>1273</sup>

The OECD position is also supported by other commentaries on Art. 7 (1) and 10 (5). Although the purpose of Art. 7 (1) is to restrict the taxing right of one contracting state from taxing the business income of a company resident in the other contracting state, CFC business profits will be taxed only on the residence state, thus CFC rules do not contradict such distributive rule in the OECD. This means that this rule does not prevent the residence state of the shareholders from taxing its residents in accordance with its domestic tax law on their profits gained through the CFC enterprise resident in the other contracting state. The computation of the tax imposed by reference to the part of the income of the CFC does not infringe such justification. Therefore the tax imposed by the residence state of a shareholder on its residents does not decrease the CFC income.<sup>1274</sup> All in all, the OECD Model in its commentary takes the position that the CFC legislation does not contradict double tax treaties.

However, the problem of applicability of domestic anti-avoidance rules to tax treaty relations remains, mainly due to the legal relevancy of the OECD commentary in deciding such solutions.<sup>1275</sup> It may be questioned whether the OECD commentary is a sufficient legal basis for applying the CFC rules in any case, or whether a special

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‘... it has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10 that this common feature of controlled foreign companies’ legislation conflicted with these provisions. [...], that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention’.

<sup>1272</sup> Commentary to Art. 1 OECD Model, 2010 para. 26.

<sup>1273</sup> *Ibid.*

<sup>1274</sup> Commentary to Art. 7 OECD-Model, 2010 para.14; Commentary to Art .10 OECD Model, 2010 paras. 37-39.

<sup>1275</sup> Rene Matteotti, ‘Interpretation of Tax Treaties and Domestic General Ant-abuse Rules-A Sceptical Look at the 2003 Update to the OECD Commentary’, *Intertax*, Vol. 33, No. 8/9, 2005, pp.336-350 at 341.

provision has to be included the OECD Model.<sup>1276</sup> For some OECD members, OECD commentaries constitute a sufficient legal basis for the denial of the benefits of the tax treaty and hence the CFC rules apply, but other states consider it an insufficient legal basis for denying tax treaty benefits.<sup>1277</sup>

In accordance with the current OECD version, some countries have concluded observations<sup>1278</sup> to the OECD commentary regarding the applicability of the domestic CFC rules.<sup>1279</sup> According to observations from *Ireland* and the *Netherlands*, it is not a simple possibility to conclude a general rule that the CFC rules and double tax treaties are not in conflict. They endorse a case-by-case approach, as deciding whether the conflict exists or not is contingent, *inter alia*, upon the correlations between domestic law and international agreements and law in the contracting states, as well as the objective and the wording of the provisions of the relevant convention.<sup>1280</sup> In cases where the anti-abuse measures are not explicitly expressed in the tax treaty, *Luxembourg* is of the opinion that domestic CFC rules can only be applied in certain cases after recourse to the mutual agreement procedure.<sup>1281</sup> In addition, *Chile and Portugal* believe that the commentary of the OECD on the application of CFC legislation cannot be applied, and thus cannot prevail over the tax treaty unless it is expressly included in the relevant tax treaty.<sup>1282</sup> Moreover, in some other states, for instance Finland, the compatibility of anti-abuse rules, including CFC legislation with double tax treaties, is generally ambiguous, i.e. it can be applied in tax treaty situations, in particular when the CFC rules are expressly mentioned in the relevant tax treaty.<sup>1283</sup> Ireland, the Netherlands, Portugal and Luxembourg have all made observations against the OECD commentary making general statements, which means that they all agree with the OECD to some extent that CFC rules are not contrary to tax treaties.

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<sup>1276</sup> IBFD, 'Courts and Tax Treaty Law', EC and International Tax Law Series, Vol. 3, 2007, at 318.

<sup>1277</sup> Michael Lang et al. *CFC legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p.31.

<sup>1278</sup> Observation is conducted when a state does not concord with commentary of the OECD, see introduction to the OECD Model, 2010 para.30.

<sup>1279</sup> The objection of these countries in form of reservation has the effect of that the application tax treaties concluded by these countries will not be impacted by the OECD commentary, this is by virtue of the reciprocity principle, see Art.21 (1) of Vienna Convention on the Law of Treaties (Vienna 1969), United Nations 2005, available at <[untreaty.un.org/ilc/texts/instruments/.../conventions/1\\_1\\_1969.pdf](http://untreaty.un.org/ilc/texts/instruments/.../conventions/1_1_1969.pdf)> accessed 12 November 2012.

<sup>1280</sup> Commentary to Art. 1 OECD Model, 2010 paras. 27.5, 27.7.

<sup>1281</sup> *Ibid*, para. 27.6

<sup>1282</sup> *Ibid*, paras. 27 and 27.3.

<sup>1283</sup> Marjaana Helminen, 'National report Finland' in Michael Lang et al. (eds.) *CFC Legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p.191.

However, *Belgium* believes that the application of CFC rules contradict Art. 5 (7), Art. 10 (5) and Art. 7 (1) of the OECD Model. Domestic CFC rules are in conflict with double tax treaties especially when the CFC rules are based on a look-through approach and the resident shareholder is taxed on income derived via a CFC resident in another country. This implies that the tax base of the shareholder is increased by means of income from a CFC that is not liable to pay tax in the residence state of the shareholder according to the tax convention. The shareholder state thus ignores the legal personality of the CFC and taxes its profits contrary to the tax treaty.<sup>1284</sup> Switzerland does not agree with the position of the OECD commentary whereby the CFC rules are compatible with a double tax treaty, especially Art. 7 (1) in some situations.<sup>1285</sup> In Germany, it has been explicitly confirmed that the CFC legislation is not inconsistent with the double tax treaty.<sup>1286</sup>

#### **5.5.5.2.2 National Courts' position**

Moreover, the national courts of some Member States remain divided on the applicability of the CFC rules in tax treaty situations. For instance, Finland and Belgium concluded a tax treaty in 1976 which strictly followed the OECD Model, and it was questioned whether the CFC legislation in Finland can be applied to the subsidiary resident in Belgium and owned by a Finnish parent company in case that such subsidiary is subject to a special tax regime therein, and thus would violate the tax treaty referred to. The Finnish Supreme Administrative Court came to the conclusion that the CFC legislation was in line with the tax treaty.<sup>1287</sup> The decision was based on the justification that it was in accordance with the OECD commentary regarding this issue. In other words, it was stated that the CFC regime is a part of the national tax rules that determine the facts which give rise to tax liability that is not dealt with by the tax treaties and therefore is not affected by tax treaties. The court provided that CFC rules are not in conflict with the wording of the objective of the tax treaty. It was also provided that tax treaties do not prevent contracting states from applying CFC rules as a recommendation

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<sup>1284</sup> See Commentary to Art. 1 OECD Model, 2010 para. 27.4; Commentary to Art. 7 OECD Model, 2010 para. 79; Commentary to Art. 10 OECD Model, 2010. Para.68.1.

<sup>1285</sup> See Commentary to Art. 1 OECD Model, 2010 para.27.9.

<sup>1286</sup> Alexander Rust, 'National report Germany' in Michael Lang et al. (eds.) *CFC Legislations, Tax Treaties and EC Law* (2004 Kluwer Law International), p.255.

<sup>1287</sup> A. Oyj Abp, 'The CFC Decision', *International Tax Law Reports*, Vol.26, No.4, 2002, p. 1009 et seq.

by the OECD report states that CFC rules should be adopted by states that do not have ones.<sup>1288</sup> However, the above reasoning is not convincing for some scholars,<sup>1289</sup> while others consider the wording of the decision may imply that the CFC rules, in certain cases, are in conflict with the Finland-Belgium tax treaty. This is because the decision of the court included the clause that [...] *the CFC regime may be applied in individual cases* [...].<sup>1290</sup>

On the other hand, the French *Conseil d'Etat* concluded that the French CFC legislation (Art. 209 B CGI) is incompatible with the amended 1969 France-Switzerland OECD-based tax treaty. Taxing the Swiss subsidiary (i.e. a CFC) of a parent company resident in France according to the French CFC rules was in particular in contradiction with Art. 7(1) of the respective treaty. This is because the France-Switzerland treaty requires an exemption for the income which may be taxed in Switzerland in accordance with Art. 7(1) on business income, especially when the CFC was resident in Switzerland, and did not have a permanent establishment in France.<sup>1291</sup> The *Conseil d'Etat* did not attribute the income of the CFC resident in Switzerland which had no permanent establishment<sup>1292</sup> in France to the French parent company. Therefore, Art.7 of the tax treaty based on the OECD Model was applicable, according to which the residence state of the CFC had the exclusive right to tax its income.<sup>1293</sup> Accordingly, the *Conseil d'Etat* concluded that a special provision in the said tax treaty would be required in order to apply the French CFC legislation.<sup>1294</sup> However, this decision has been exposed to criticism on the basis that the attribution of income to a certain entity or individual is determined by domestic legislature and the legal system. In doing so, the relevance of the constitution provisions are taken into account, hence the tax treaty does not

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<sup>1288</sup> Marjaana Helminen, 'National report Finland' in Michael Lang et al. (eds.) *CFC Legislations, Tax treaties and EC Law*' (2004 Kluwer Law International), p.191.

<sup>1289</sup> Michael Lang, *CFC regulations and Double Taxation Treaties* (2003 IBFD), p.56.

<sup>1290</sup> Marjaana Helminen, 'National report Finland' in Michael Lang et al. (eds.) *CFC Legislations, Tax treaties and EC Law*' (2004 Kluwer Law International), p.191.

<sup>1291</sup> Conseil d' Etat 28 June 2002, *SA Schneider Electric*, No232276, 4, International tax Law Reports 2002, at 1077.

<sup>1292</sup> According to Art. 7(1) of the OECD Model [...] 'the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein'

<sup>1293</sup> Gutman/, Danon, Salome, 'French-Swiss Point of view on the SA Schneider Electric Case: Some Thought on the Personal Attribution of Income Requirement in International Tax Law', *Intertax*, 2003, Vol.31, p.156 et seq.

<sup>1294</sup> Conseil d' Etat 28 June 2002, *SA Schneider Electric*, No232276, 4, International tax Law Reports 2002, at 1077; see also Douvier, Bouzora, 'France: Court of Appeal confirms Incompatibility of CFC rules with Tax Treaties', *European Taxation*, 2001, p. 184, at 185 et seq.

determine income attribution independently, but the distributive rules in the tax treaties are based on the national law attribution decisions.<sup>1295</sup>

### **5.5.5.2.3 Arguments for and against applicability of CFC rules in tax treaty relations**

The issue of the interaction between the domestic CFC rules and double tax treaties is controversial and unsettled in ongoing academic literature.<sup>1296</sup> On the one hand, some authors tend to agree that CFC rules are in line with double tax treaties that are based on the OECD Model. Their arguments are supported by the position of the OECD commentaries (i.e. the tax treaty has the purpose of eliminating tax abuse) and the positive national courts' decisions on compatibility of the CFC rules, such as the Finnish Supreme Administrative Court decision, as mentioned above.<sup>1297</sup>

On the other hand, some scholars are of the opinion that the CFC legislation is not compatible with the double tax treaties for some reasons. Current tax treaties do not contain any provisions on the CFC rules; they are only referred to in the commentary of the OECD Model. The relevance of the OECD commentary is questionable; it just a part of soft law and is not considered as justified interpretation as it goes beyond the wording of treaty provisions.<sup>1298</sup> In some cases, the compatibility issue is contingent on the interpretation of the tax treaties by the domestic administrations and not the OECD commentary.<sup>1299</sup>

Moreover, the OECD argument that the CFC rules are part of the domestic law, and thus are not affected by tax treaties, lacks a solid justification. The distributive provisions in tax treaties affect the taxable event, especially in respect to its territorial scope; for example, it limits the source principle or the territorial effect of the residence principle. Consequently, the OECD stance on the applicability of CFC rules to tax treaty

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<sup>1295</sup> Michael Lang, *CFC regulations and Double Taxation Treaties* (2003 IBFD), p.53.

<sup>1296</sup> Some scholars tends to agree that CFC rules are in conflict with tax treaties if they applied under deemed dividends approach, i.e. on conflict with article 10 of the OECD Model, see Alexander Rust , *CFC Legislation and EC Law*, Intertax , Vol. 36 , 2008,p.492.

<sup>1297</sup> Marjaana Helminen, 'National report Finland' in Michael Lang et al. (eds.) *CFC Legislations, Tax treaties and EC Law*' (2004 Kluwer Law International), p.200.

<sup>1298</sup> Katerina Perrou, 'The Judicial Application of Anti-avoidance Doctrine in Greece and its Impact on International Tax law', Intertax, Vol. 34, No. 2, 2006, pp.101-108, at 102.

<sup>1299</sup> Marjaana Helminen, 'Is There a Future for CFC-regimes in the EU?' Intertax, Vol. 33, No. 3, 2005, pp.117-123 at 118.

situations seems to be an exception to the articles of its provisions, such as Art.7, or to the principles already established in the current tax treaties.<sup>1300</sup>

Other scholars are sceptical that tax treaties have the objective of eliminating tax-avoidance, even though it is stated in the OECD commentary.<sup>1301</sup> In other words, the distributive rules of the OECD-based tax treaties mainly have the purpose of avoiding double taxation, whereas prevention of tax avoidance is only mentioned in the commentary, and not in the OECD distributive provisions.<sup>1302</sup> Therefore, it will not be acceptable to deny the tax treaties benefits, i.e. applying the CFC legislation, without special provisions being contained in the relevant tax treaty.<sup>1303</sup>

Arguably, the prevention of tax-avoidance is not among the tax treaty purposes, because it is vaguely stated in the OECD commentary and is not included in the double tax treaty provisions. However, in accordance with Art. 31(1) of the Vienna Convention on Tax Treaties Law (VCTL) a '*purposive interpretation*' should be promoted. Nevertheless, the purpose of the tax treaties should not grant the *terms* of the tax treaties a meaning beyond what is expressly stated in such treaty provisions, i.e. the purpose of the tax treaty is not the main parameter to be taken into account in interpreting the tax treaty provisions under Art.31(1). If the ordinary meaning of the relevant terms and context are also taken into account, they could be given much weight to the ambiguous statement of the OECD commentary.<sup>1304</sup> Therefore, the implicit existence of anti-abuse rules, including the CFC rule in OECD-based tax treaties, is not supported by

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<sup>1300</sup> Martín Jiménez, A.J., 'Domestic Anti-Abuse rules and Double Taxation Treaties: a Spanish Perspective - part II' Bulletin for International Fiscal Documentation, Vol. 56, No. 12, 2002, pp. 620-626, at 625.

<sup>1301</sup> Commentary to Art. 1 OECD Model, 2010 para. 7.

<sup>1302</sup> Brian J. Arnold and Stef van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-abuse Measures', in Guglielmo Maisto (ed.) *Tax Treaties and Domestic Law* (IBFD 2006), pp.81-120 at 90.

<sup>1303</sup> see Martine J. Peters, 'National Report of Netherlands', pp.433,435; Birgitta Glad, 'National Report of Norway', pp.489-526; Ricardo Borges, 'National Report of Portugal', pp.527-558; Linda Favi, 'National Report of Italy', pp.349-390; Georgios Matsos, 'National Report of Greece', pp.281-302; Von Frenckell, 'National Report of Belgium', pp.97-124; Kabbaj/Raingear, 'National Report of France' in Michael Lang et al. (eds.) *CFC legislations, Tax Treaties and EC Law* (2004 Kluwer Law International); Michael Lang, *CFC Regulations and Double Taxation Treaties* (2003 IBFD) ,p. 51 et seq.

<sup>1304</sup> Brian J. Arnold and Stef van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-Abuse Measures', in Guglielmo Maisto(ed.) *Tax Treaties and Domestic Law* (IBFD 2006),p. 90

international tax law, especially in Art. 31(1)<sup>1305</sup> of VCTL on the treaty interpretation and Art. 26 of VCTL on the good faith principle.<sup>1306</sup>

Under the assumption that tax treaties have the purpose of eliminating tax-avoidance or at least of not facilitating tax abuse practices,<sup>1307</sup> some authors find that the main problem of the compatibility of CFC rules with tax treaties is caused by the disparity between the domestic tax systems and the correlative differences in the legal treatment of abusive practices' by the contracting states under their tax treaties. In other words, there are no minimum tax abuse standards in the different national tax law systems; the application scope of any domestic anti-abuse rules depends on the policy and the structure of the domestic law concerned, and on the constitutional framework for tax law interpretation. Consequently, certain arrangements can be considered as an abusive practice under the tax statute of one contracting state, while it is legitimate under the statutory setting of another country.<sup>1308</sup> Therefore, it would be a daunting task to establish anti-abuse provisions in tax treaties.

The OECD commentary attempted to establish a standard tax treaty anti-abuse rule. It states that, in the context of the tax treaty, a transaction would be considered as abusive, and thus be subject to domestic anti-abuse rules, if such transaction mainly aims to obtain treaty benefits and obtaining these benefits are contrary to the purpose of the relevant provisions of the tax treaty.<sup>1309</sup> However, this statement can be seen to be vague, i.e. particular situations need to be specified in which the tax treaty benefits are granted, and where the purpose of the tax treaty is frustrated by such transactions, as in the case of CFC rules.<sup>1310</sup> The OECD commentary does not constitute a theory on the abuse of tax treaty,<sup>1311</sup> it is merely a guiding principle, as it does not provide for a

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<sup>1305</sup> Vienna Convention on the Law of Treaties, Art.31, 1969.

<sup>1306</sup> Luc De Broe, *International Taxation Planning and Prevention of abuse* (IBFD, 2008), pp.374-376; Sandler, Daniel, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* (2nd edition, Kluwer Law International, London 1998), p.310.

<sup>1307</sup> Stef Van Weeghel, *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States* (Kluwer Law International 1998), p.35.

<sup>1308</sup> Rene Matteotti, 'Interpretation of Tax Treaties and Domestic General Anti-abuse Rules-A Sceptical Look at the 2033 Update to the OECD Commentary', *Intertax*, Vol. 33, No. 8/9, 2005, pp.336-350 at344.

<sup>1309</sup> Commentary to Art 1 OECD Model, 2010 para .9.5.

<sup>1310</sup> Brian J. Arnold and Stef van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-Abuse Measures', in Guglielmo Maisto (ed.) *Tax Treaties and Domestic Law* (IBFD 2006), p.93.

<sup>1311</sup> Adolfo J. Martin Jimenez, 'Domestic Anti-abuse Rules and Double Taxation Treaties: a Spanish Perspective-Part 1', *BIFD*, Vol. 56, 2002, pp. 542-553, at 545.



precise definition of an abusive transaction.<sup>1312</sup> In any case, this general guiding principle would not cover the CFC rules.

All in all, the consistency of the CFC rules with the tax treaties is far from being settled in most cases. Therefore, it is suggested that the only way to deal with all such problems is to insert special provisions in the double tax treaties denying access to treaty benefits on the basis of abusive practices.<sup>1313</sup>

#### **5.5.5.2.4 The application of the CCCTB's CFC rules in tax Treaty relations**

Against the above arguments, first of all, a decision on whether the CCCTB's CFC rules are applicable in tax treaty situations cannot be sought from the courts' remarks. As noted above, the judiciary position is divided regarding this issue.<sup>1314</sup> It can be observed that the issue of the CFC rules' applicability in tax treaty relations is generally triggered by ambiguity over whether double tax treaties have a tax-abuse elimination purpose, and particularly by the absence of specific anti-abuse provisions, such as CFC rules, in many of the existing tax treaties. The OECD attempts to diminish the problem by providing its interpretive commentary, which states that tax treaties have the objective of tax-abuse prevention, but the problem remains, due to the legal relevance of this commentary to tax treaty interpretation. In addition, the commentary is not legally binding on the relevant OECD Member States. Even assuming that the OECD position in this respect is acceptable, it seems that the question of compatibility between CFC rules and tax treaties would persist, due to the disparity between the domestic tax systems and the tax policies of the contracting states on tax abuse practices. In other words, despite the fact that the structures of CFC legislations are somewhat similar in most countries, there is no minimum standard on tax abuse rules, i.e. the contracting states treat abusive practices – of which the CFC rules are part – differently.

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<sup>1312</sup> Martín Jiménez, A.J., 'The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?', *Bulletin for International Fiscal Documentation*, Vol. 58, No. 1, 2004, pp. 17-30, at 27.

<sup>1313</sup> Katerina Perrou, 'The Judicial Application of Anti-avoidance Doctrine in Greece and its Impact on International Tax Law', *Intertax*, Vol. 34, No. 2, 2006, pp. 101-108, at 101.

<sup>1314</sup> Balint Liszicza, 'National Report Hungary', in Michael Lang et al. *CFC legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p. 303.

Since the CCCTB Directive provides for common anti-abuse rules, including CFC legislation, this common approach would alleviate the compatibility issue. This means that the issue at stake would not be the correlative lack of homogeneity in the legal treatment of the CFC's abusive practices by different EU-Member States; rather, it would be narrowed to the absence of special provisions on CFC rules in tax treaties. In the long run, it would be possible to include the common anti-abuse rules which are agreed upon by CCCTB-Member States in tax treaties. However, the short term solution provided by the CCCTB Directive, i.e. the overriding by the tax treaties, would result in a conflict between CCCTB's CFC rules and current tax treaties concluded with third countries. The tax treaty provisions that are subject to conflict need to be identified (if any were to arise), in order to be amended in the long run. Therefore, the compatibility of the CCCTB's common CFC rules with the distributive provisions of current OECD-based tax treaties will be examined.

#### **5.5.5.2.5      Distributive rules in tax treaties that may conflict with the CCCTB's CFC rules**

The CFC regime in the CCCTB allows the taxation of the undistributed income of a CFC resident in third country by including such profits into the tax base of the CCCTB taxpayer. The shareholder *taxpayer*, by itself or together with its associated enterprise, is liable to impose tax on the part of the undistributed profits of the CFC corresponding to its proportionate beneficiary position in the CFC.<sup>1315</sup> In order to examine the compatibility of the CCCTB's CFC rules with tax treaties, it needs to be determined which distributive provisions of the OECD Model deal with income attribution to a shareholder resident in the CCCTB-jurisdiction. Then it should be determined whether such attribution of such income accords with the taxation under the CCCTB's CFC rules.

Determination the extent to which the CCCTB's CFC rules conflict with distributive provisions of tax treaties depends on two parameters. Firstly, on which forms of distributable CFC income are subject to tax in the residence state of the shareholder. The CCCTB's CFC legislation is phrased in such a manner that the profit income including dividends is subject to tax, thus Art. 10 of the OECD Model would be of

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<sup>1315</sup> See Arts.82 (1), 83(2) of the CCCTB Directive.

relevance. Second, it depends on the underlying concept of the CFC legislation, i.e. whether the CCCTB's CFC rules are based on the *piercing the veil* approach or the *deemed distribution* approach.<sup>1316</sup> In other words, whether the income taxed according to the CCCTB's CFC rules qualifies as CFC income or as a resident shareholder's income. As has been established in the previous chapter, the CCCTB's CFC rules are based on the deemed distribution approach, and the examination that follows will proceed on this basis.

#### **5.5.5.2.6 The CFC regime in the CCCTB based on the deemed distribution approach**

##### **5.5.5.2.6.1 Article 7 in the OECD Model**

Since, according to the deemed distribution approach, the CCCTB's CFC rules recognise the CFC resident in a third country as a separately taxable entity, and only regards the distribution to exist, the CFC is treated as a separately taxable entity in both the state of its residence and the residence Member State of the shareholder.<sup>1317</sup> In this case, it would be disputed whether the residence Member State of the shareholder is allowed to tax non-distributed business income of the separately taxable company resident in a third country.<sup>1318</sup>

In principle, under Art. 7 of the OECD Model, a taxing right over the business income of the CFC is exclusively given to its residence state. The residence state of the shareholder is not entitled to tax the CFC income, unless the respective CFC has a permanent establishment in the residence estate of the shareholder. Nevertheless, pursuant to the OECD commentary, Art. 7 (1) only prevents the residence state of the shareholder from taxing the business income of the CFC which is resident in another state, but it does preclude the residence state of the shareholder from taxing its own residents according to the CFC legislation applicable therein. The tax imposed on the

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<sup>1316</sup> Daniel Sandler, *Tax Treaties and Controlled Foreign Company: Pushing the Boundaries* (2ed edition The Hague: Kluwer Law International 1998), p.108.

<sup>1317</sup> The CFC qualifies as a third-country resident company under an OECD-based tax, see M. Helminen, 'National Report Finland', in Michael Lang et al. *CFC legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p.208.

<sup>1318</sup> *Ibid.*

income obtained by the shareholder via the CFC does not reduce the income of the CFC, thus it cannot be said to be directly levied on it.<sup>1319</sup>

Similarly, having said that the CCCTB's CFC rules are drafted pursuant to the fictitious distribution approach, which treats the CFC as a separate entity from its shareholder, Art. 7 of the OECD Model does not preclude a CCCTB-Member State from taxing the income of its resident shareholder according to the CFC legislation, i.e. income that is gained through a CFC resident in a third country. Therefore, the CFC rules in the CCCTB do not seem to be contrary to the tax treaties provision equivalent to Art.7 of the OECD Model.

#### **5.5.5.2.6.2 Article 10 OECD Model**

Under Art. 10 of the OECD Model, the residence state of the shareholder is allowed to tax the dividends distribution *paid* by a company that is resident in the source state. Nonetheless, the source state is also permitted to impose a limited source tax on the distributed dividends. Among the income that is taxed according to the CCCTB's CFC rules are *undistributed dividends*.<sup>1320</sup> Since Art. 7 of the OECD Model does not apply to the distributions that are characterised as dividends pursuant to Art. 10 of the OECD, Art. 10 prevails over it in this respect. Hence, it seems that Art. 10 of the OECD Model is applicable in the case of the CCCTB's CFC rules. However, as the residence country of the CFC has the right to levy tax on dividends under the source taxation principle, Art. 10 OECD provides<sup>1321</sup> that the source state should determine what constitutes dividends. Therefore it is argued that applying Art. 10 OECD to the CFC rules depends on the domestic law of the residence country of the CFC,<sup>1322</sup> because what is considered as dividends therein may not be deemed so in the sense of a tax treaty or in the recipient CCCTB-Member State.<sup>1323</sup> Under the assumption that the definition of dividend is the same in both the source country (third country) and the recipient state (CCCTB-Member State), the latter has the right to tax dividends distributed by the CFC resident in the third country.

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<sup>1319</sup> Commentary to Art. 7 OECD Model, 2010 paras.10-14.

<sup>1320</sup> Art.4 (8) of the CCCTB Directive.

<sup>1321</sup> Art. 10(3) of OECD Model.

<sup>1322</sup> Martine J. Peter, 'National Report the Netherlands' in Michael Lang et al. *CFC legislations, Tax treaties and EC law* (2004 Kluwer Law International), pp.433-462.

<sup>1323</sup> Balint Liszicza, 'National Report Hungary' in Michael Lang et al. *CFC legislations, Tax Treaties and EC Law* (2004 Kluwer Law International), p.310.

However, Article 10 (1) of the OECD Model requires actual payment of dividends in order for them to be taxed in the hands of the shareholder in its residence state, but the CCCTB's CFC rules taxes deemed dividends.<sup>1324</sup> Under the OECD commentary, the term 'paid' has a very wide meaning. Fulfilment of the obligation of putting the funds of the company at the disposal of the shareholders should be a sound understanding of the term 'paid'.<sup>1325</sup> However, under the deemed dividends distribution, no actual funds are put at the disposal of the shareholder; in addition, the ordinary meaning of the term 'paid' does include the fictive distribution of dividends.<sup>1326</sup> Furthermore, the OECD commentary, which can justify taxing deemed dividends, states that the income of shareholders cannot be taxed unless it is actually distributed by the company, except where the domestic law of certain countries relating to taxation of undistributed profits states otherwise and in 'special cases'.<sup>1327</sup> It is submitted that such commentary is not precisely what is meant by 'special cases' is the CFC rules, but at least it implies that the deemed dividend can be subject to Art. 10 OECD Model, and thus taxed under the CFC rules.<sup>1328</sup> Therefore, non-distributed dividends are subject to Art. 10 OECD Model if the domestic legislature concerned provides so.<sup>1329</sup> The CCCTB's CFC rules do not contravene Art. 10(1) of the OECD Model.

Moreover, the CCCTB's CFC rules could contradict Art. 10(5) OECD Model. Generally, Art. 10 deals with dividends paid by a company resident in a contracting state to a shareholder resident in another contracting state.<sup>1330</sup> However, certain countries additionally tax dividends distributed by non-resident companies merely because such dividends are sourced in their territory. This *proviso* prevents extra territorial taxation of dividends by preventing the source country from taxing such dividends unless it is paid to a resident therein, unless the dividends are paid to a

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<sup>1324</sup> Art. 28 (3(c)) of the CCCTB Directive.

<sup>1325</sup> Commentary to Art. 10(1) OECD Model, 2010 para. 7.

<sup>1326</sup> P. J. Wattel and O. Marres, 'Characterization of Fictitious Income under OECD-Patterned Tax Treaties', *European Taxation*, Vol. 43, No. 3, 2003, pp. 66-79, at 70.

<sup>1327</sup> Commentary to Art. 10 OECD Model, 2010 para. 3.

<sup>1328</sup> Martine Glad, 'National Report Norway' in Michael Lang et al. *CFC legislations, Tax treaties and EC law* (2004 Kluwer law International), p.323.

<sup>1329</sup> Michael Lang, *CFC Regulations and Double Taxation Treaties* (2003 IBFD), p.56; Michael Lang et al. *CFC legislations, Tax treaties and EC Law* (2004 Kluwer Law International), p.33.

<sup>1330</sup> Commentary to Art 10(5) OECD Model, 2010, para. 33.

resident in the state where the income is sourced.<sup>1331</sup> It also provides that the undistributed dividends of the non-resident company should not be subject to tax in the source state, even if the undistributed dividends have wholly or partly originated therein.<sup>1332</sup>

As far as the compatibility of Art. 10(5) with the CFC rules is concerned, the OECD takes the stance that Art.10 (5) is targeting only the source taxation (in this case, the CFC residence state), thus it does not affect the application of the CFC rules.<sup>1333</sup> According to the CCTB's CFC rules, the shareholder of the foreign company is resident in the state in which the CFC rules apply, therefore it falls under the tax sovereignty of that state, meaning that paragraph (5) is not relevant to the application of CFC rules. Moreover, the paragraph is only related to the taxation of the company and has nothing to do with the taxation in the residence state of the shareholders of the company.<sup>1334</sup> For the above reasons the CFC rules in the CCCTB are not contrary to Art.10 (5) in the OECD Model.<sup>1335</sup>

#### **5.5.5.2.6.3 Double taxation in the context of the CCCTB's CFC rules**

The application of the CFC rules would sophisticate the application of a tax treaty's provisions on the elimination of double taxation. Implementing the CFC rules could result in an economic double taxation due to the state level income tax paid by the CFC in its residence state and the taxes imposed on the same income when attributed to the shareholders in its residence state. Nevertheless, the OECD provisions which deal with the elimination of double taxation do not target the prevention of international economic double taxation in relation to the CFC income when it falls under the scope of Art. 10 OECD.<sup>1336</sup> Therefore, it has been argued that there is no need for relieving such international economic double taxation by providing tax credit in the CFC rules.<sup>1337</sup> It is evident that the domestic CFC rules in some countries eliminate the economic double

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<sup>1331</sup> Commentary to Art .10(5) OECD Model, 2010, para. 34.

<sup>1332</sup> *Ibid*, para. 36.

<sup>1333</sup> *Ibid*, para. 37.

<sup>1334</sup> *Ibid*.

<sup>1335</sup> Michael Lang, *CFC Regulations and Double Taxation Treaties* (2003 IBFD), p.56.

<sup>1336</sup> Marjaana Helminen, 'National Report Finland' in Michael Lang et al. *CFC Legislations, Tax Treaties and EC Law* (2004 Kluwer Law International), p191, at 204 et seq.

<sup>1337</sup> *Ibid*.

taxation related to taxation of the CFC income.<sup>1338</sup> As mentioned, the CCCTB Directive prevents economic double taxation if the CFC distributes profits in a subsequent year. Accordingly, the income previously included in the tax base of the shareholder pursuant to the CFC rules will be deducted when the CFC's profits are disposed of.<sup>1339</sup>

As regards the elimination of judicial double taxation, the CCCTB Directive states that undistributed income of the CFC, which will be included in the tax base of the shareholder pursuant to the CFC rules, will be calculated according to Arts. 9 to 15 of the CCCTB Directive.<sup>1340</sup> This implies that distributable profits, including dividends, from the CFC will be exempt.<sup>1341</sup> This renders the CFC rules not applicable. However, if the switch-over clause applies, the undistributed dividends will be included in the tax base and hence the CFC rule will be effective. Nonetheless, the switch-over clause applies only to distributed profits. When the actual distribution of the CFC profits takes place it would be subject to the switch-over clause (as they are low-taxed profits in a third country).<sup>1342</sup> However, it would not satisfy the conditions for a foreign tax credit as it would be deducted from the shareholder's tax base due to its previous inclusion. Hence, there would be no basis for granting foreign tax credit.

Moreover, the treatment of the actual distribution of the CFC income is problematic with respect to double tax treaties. The undistributed income of the CFC income has been previously taxed in the residence state of the shareholders, then in the scenario of actual distribution, the CFC is regarded as dividend-distributing and the income received by the shareholders could qualify as a dividend under tax treaty between the residence state of the CFC and the shareholders' residence state. Since the CFC residence state is allowed to impose withholding tax on the CFC distribution, and the distributed income is previously taxed in the hands of the shareholders as a CFC income, the problem of double taxation and granting tax credit for foreign tax paid arises. In other words, in accordance with the applicable tax treaty, the residence state of the shareholders may be required in order to give a relief for withholding tax paid in the

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<sup>1338</sup> For example Finland see, *Ibid.*

<sup>1339</sup> Art. 83 of the CCCTB Directive.

<sup>1340</sup> Art. 83 (1) of the CCCTB Directive.

<sup>1341</sup> Art. 11 of the CCCTB Directive.

<sup>1342</sup> Art. 73 of the CCCTB Directive.

source country, i.e. the CFC residence state.<sup>1343</sup> However, because the distributed income is not included in the tax base of the shareholder, ‘there is no tax against which the foreign withholding tax can be credited’.<sup>1344</sup> Therefore, the judicial double taxation would remain unrelieved, contrary to the double tax treaty provisions.

In reaction to such a problem, the OECD suggested that the withholding taxes on dividends should be credited in the residence country of the shareholders only to avoid the frustration of the double taxation treaty.<sup>1345</sup> However, granting a credit for withholding tax paid at source would infringe the effect of the CFC regime in the CCCTB. In any case, the CCCTB’s CFC rules have an escape clause under which the CFCs which are resident in a third country which is a party of the European Economic Area Agreement where there is an active mechanism for exchange of information are not subject to CFC rules. This could alleviate the above downside of the CFC rules.<sup>1346</sup>

### **5.5.5.3 CCCTB’s thin capitalisation rules and double tax treaties**

The CCCTB’s thin capitalisation rules apply only to interest paid to an associated enterprise resident in a third country, i.e. debt financing provided by a non-resident.<sup>1347</sup> The thin capitalisation rules drafted in the CCCTB regime are likely to interact with third-country double tax treaties. In other words, where there is an OECD-based tax treaty between the CCCTB-Member States and the residence country of the creditor, the application of thin capitalisation rules has to be tested against Arts. 9 and 24 of the OECD Model.

In principle, Art. 9 of the OECD Model allows the tax authorities to adjust the profits of a resident company where the transactions entered into between such company and a foreign related company does not *respect the arm’s length principle*. According to this article, the application of domestic thin capitalisation rules is permitted, insofar as they are formulated under the arm’s length approach, i.e. assimilating the profits of the debtor to an amount comparable to the profit which would have been attained on the

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<sup>1343</sup> Marjaana Helminen, ‘National Report Finland’ in Michael Lang et al. *CFC Legislations, Tax Treaties and EC Law* (2004 Kluwer Law International), p. 207.

<sup>1344</sup> Art.83 (4) of the CCCTB Directive.

<sup>1345</sup> Commentary to Art 10(5) OECD Model, 2010 para. 39.

<sup>1346</sup> Art.82 (2) of the CCTB Directive.

<sup>1347</sup> Art.81 (1) of the CCCTB Directive.



arm's length basis.<sup>1348</sup> This approach *prima facie* focuses on the exact nature of the funding, in the light of all facts and circumstances, to estimate whether it can be regarded as a loan or is merely another kind of payment. It also appraises whether the interest rate provided for the loan is an arm's length rate or not. Nevertheless, the effect of the application of thin capitalisation rules should not lead to an increase in the taxable profits of the debtor company that is greater than the arm's length profits.<sup>1349</sup>

Since, according to the OECD's position,<sup>1350</sup> Art. 9 (1) applies to both the amount of interest paid on a certain loan and the amount of the loan itself, this implies that the provision is applicable in thin capitalisation situations; however, it is argued that the text of the article itself does not sustain this meaning.<sup>1351</sup> Furthermore, transfer pricing rules are commonly applied only to the rate of interest, not to the amount of the debt. However, *status quo*, most countries that employ thin capitalisation rules apply transfer pricing rules to thin capitalisation situations, in accordance with the OECD's stance.<sup>1352</sup> It seems that the transfer pricing rules in the CCCTB regime would apply to thin capitalisation situations in conjunction with the thin capitalisation rules.<sup>1353</sup> Therefore, in accordance with Art. 9(1) of the OECD Model, transfer pricing under the arm's length principle extends to thin capitalisation practices, and transfer pricing rules in the CCCTB system would apply to thin capitalisation situations. Accordingly, the question arises as to *whether the CCCTB's thin capitalisation rules are compatible with the arm's length principle in Art. 9 (1) of the OECD Model?*

As designated by the OECD's commentary, Art. 9(1) does not forestall the thin capitalisation rules' application, to the extent that their effect is to approximate the profits that would have occurred from transactions between enterprises operating at arm's length.<sup>1354</sup> Consequently, if the thin capitalisation rules do not depart from the

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<sup>1348</sup> Commentary to Art. 9(1) OECD Model, 2010 para.3.

<sup>1349</sup> *Ibid.*

<sup>1350</sup> OECD Report on 'Thin Capitalisation', the OECD Committee on Fiscal Affairs, 1986, paras. 84-50; Commentary to Art. 9(1) OECD Model, 2010 para. 3.

<sup>1351</sup> Fred C. de Hosson & Geerten M.M. Michielse, 'Treaty aspects of 'Thin Capitalisation' Issue: A Review of the OECD Report', *Intertax*, No. 11, 1989, pp. 476-484, at 483.

<sup>1352</sup> Detlev J. Piltz, 'General Report' in International Fiscal Association, '*International Aspects of Thin Capitalization*', vol. 81b (The Hague: Kluwer, 1996), pp. 83-139, p. 129.

<sup>1353</sup> European Commission, 'CCCTB: Possible Elements of a Technical Outline', (CCCTB/WP057/doc/en), para.44.

<sup>1354</sup> Commentary to Art. 9(1) OECD Model, 2010 para. 3, for the same meaning see ECJ C-524/04, '*Thin Cap Group Litigation v Commissioners of Inland Revenue*' [2007] ECR I-02107, para.71.

arm's length basis in respect to the excess portion of the loan or the interest rate, there will be no conflict with Art. 9(1) of the OECD Model.<sup>1355</sup>

Moreover, in the event that thin capitalisation rules (as a proxy for the arm's length approach), are formulated pursuant to the 'fixed ratio' basis, i.e. where a company's total debt exceeds a ratio of its equity, the interest on the loan in excess of the fixed ratio is disallowed as a deduction. Thin capitalisation rules would be compatible with the arm's length principle provided that the 'fixed ratio' is employed as a 'safe harbour' and that the taxpayer has the opportunity to demonstrate that its actual debt-to equity ratio is an arm's-length ratio.<sup>1356</sup> This means that if a certain thin capitalisation rule is based on a fixed ratio approach without providing this option, it would be contrary to Art. 9 (1) of the OECD Model.<sup>1357</sup>

As mentioned in the preceding chapter, the CCCTB's thin capitalisation rules are neither based on the arm's length test nor on the 'fixed ratio' approach, rather the deduction of interest payment to low-tax third countries is denied under the presumption that the payment is made solely for fiscal purposes. Generally, this presumption can be refuted when the taxpayer proves that this payment is justified by certain *reasons* such as an arm's length calculation or economic justification. Nonetheless, under the CCCTB Directive<sup>1358</sup> the arm's length approach is not included among the escape clause cases. Moreover, the effect of the CCCTB's thin capitalisation rules would lead to an increase in the taxable base of the CCCTB taxpayer, as the non-deductibility of interest paid to low-tax third country is not *limited to the amount* that would be stipulated at arm's length. It is, however, non-deductible *in whole*.<sup>1359</sup> Therefore, the CCCTB's thin capitalisation rules are not consistent with the arm's length principle and are *undoubtedly in breach of Art. 9(1) of the OECD Model*.

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<sup>1355</sup> Jinyan Li and Daniel Sandler, 'The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties', Canadian Tax Journal, Vol. 45, No. 5, 1997, pp.891-958, at 930.

<sup>1356</sup> OECD Report on 'Thin Capitalisation', the OECD Committee on Fiscal Affairs, 1986, para.79.

<sup>1357</sup> *Ibid.*

<sup>1358</sup> See the three 'escape clause' cases provided in Art.81 (3) of the CCCTB Directive.

<sup>1359</sup> Art.81 (1) of the CCCTB Directive.

### 5.5.5.3.1 Thin capitalisation rules and non-discrimination provision

The concept of non-discrimination is established in the OECD Model in Art. 24 and it forbids discrimination, based on four different situations: the taxpayer's nationality (Para.1); the permanent establishment of a non-resident in another jurisdiction (Para. 3); the payments of interest and other considerations to non-residents (Para. 4), and the holding of shares in a resident company by non-residents (Para. 5).<sup>1360</sup> Only paragraphs 4 and 5 are relevant to thin capitalisation rules.

Under Art. 24 (4) of the OECD Model,<sup>1361</sup> interest paid by a company of a contracting state to a resident of the other contracting state has to be deductible in the same manner as if the interest amount has been paid to a resident of the first-mentioned state. This paragraph prohibits discrimination<sup>1362</sup> between a non-resident lender and the resident lender in respect to the disallowance of interest deduction.<sup>1363</sup> In other words, in certain countries interest paid to a *resident* is deductible, whereas when the interest is paid to a *non-resident* the deduction is restricted. This is regarded as discriminatory.<sup>1364</sup>

However, as an exception, Art. 24 (4) does not preclude the application of domestic thin capitalisation rules to the extent that they are consistent with the arm's length principle under Art.9 (1) OECD Model. The thin capitalisation rules manifestly put restrictions on the deductibility of interest paid to non-residents, but these restrictions do not apply to interest paid to residents. Thus, paragraph 24(4) implies that a debtor company is

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<sup>1360</sup> For a good clarification on Art.24 of the OECD Model see Silke Bruns, 'Taxation and Non-discrimination: Clarification and Reconsideration by the OECD', *European Taxation*, September 2009, pp.484-492.

<sup>1361</sup> For a general overview of Art. 24 of the OECD Model see John Avery Jones, Catherine Bobbett, 'Interpretation of the Non-discrimination Article of the OECD Model', *Bulletin For International Taxation*, February 2008, pp.50-55.

<sup>1362</sup> Discrimination is generally defined as the application of different treatment to comparable situations, or the application of the same treatment to different situations, without reasonable justifications; see ECJ C-279/93, *Finanzamt Köln-Altstadt vs. Roland Schumacker* [1995] ECR I-00225, para.30; Bruno Santiago, 'Non-discrimination provisions at the Intersection of EC and International tax law', *European Taxation*, May 2009, pp.249-262 at 254.

<sup>1363</sup> Commentary to Art .24(4) OECD Model, 2010 para. 73.

<sup>1364</sup> Article 24 (4) of the OECD Model, 2010 reads as follows:

'Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interests, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits such enterprise, be deductible under the same conditions as if it had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State'.

allowed to deny the deductibility of interest paid to a non-resident creditor under its thin capitalisation rules in so far as these rules are in conformity with Art. 9 (1) of the OECD Model, without being in breach of the non-discrimination provision.<sup>1365</sup> However, this treatment will be regarded as discriminatory if the thin capitalisation rules are in breach of the arm's length principle. *Since the CCCTB's thin capitalisation rules arguably contravene Art. 9(1) of the OECD Model, similarly they are in breach of Art. 24(4).*

Art.24 (5) of the OECD Model<sup>1366</sup> prevents a contracting state from giving less favourable treatment to a company when the capital of that company is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other contracting state.<sup>1367</sup> It is submitted that pursuant to this paragraph, where the interest deduction is allowed in relation to the company *controlled* by a resident and disallowed in respect to a company which is *controlled* by a non-resident, this can be regarded as discriminatory treatment. Therefore, if the thin capitalisation rules operate on the basis of ownership control, i.e. apply mainly if an entity in a certain country is controlled by a non-resident, it would contradict the non-discrimination provision.<sup>1368</sup>

However, the OECD commentary expressly demonstrated that Art.24 (5) only precluded discrimination that is based on ownership control. Where the thin capitalisation rules treat a company differently based on whether it pays interest to a resident or non-resident creditor, thus it predominantly relates to the relationship between debtor and creditor. Art 24(5) is not relevant to thin capitalisation rules in so far as the different treatment provided by these rules is not based on whether or not a non-resident owns or controls the capital of the company.<sup>1369</sup>

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<sup>1365</sup> Commentary to Art .24(4) OECD Model, 2010 para.74.

<sup>1366</sup> This paragraph reads as follows:

‘Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subject in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subject. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States’.

It can be noticed that, unlike Art. 24 (4), in Art. 24 (5), there is no exception for the arm's-length principles that adopted by Article 9 (1).

<sup>1367</sup> Commentary to Art. 24(5) OECD Model, 2010 para.76.

<sup>1368</sup> Craig Elliffe, ‘Thin Capitalisation Rules and Treaties: Does the Ratio in the New Zealand Thin Capitalisation Rules Contravene New Zealand’s Tax Treaty Obligations?’ p.4, Electronic copy available at: [http <://ssrn.com/abstract=2120839>](http://ssrn.com/abstract=2120839) accessed 15 December 2012.

<sup>1369</sup> Commentary to Art. 24(5) OECD Model, 2010 para.79.

Applying this analysis to the CCCTB system, thin capitalisation rules apply to the interest paid by a resident company to an associated enterprise resident in a third country irrespective of who controls or owns the resident company.<sup>1370</sup> Thus, it can be concluded that the CCCTB's thin capitalisation rules are not in breach of Art. 24 (5) of the OECD Model, because *foreign ownership is not the main cause* of the application of the CCCTB's thin capitalisation rules.<sup>1371</sup>

#### **5.5.6 The quest for solution that eliminates incompatibility of the CCCTB rules with third-countries tax treaties**

By opting for the CCCTB system, the EU Member States agree on common rules to be applied internationally, such as a method for elimination of double taxation and anti-abuse rules applicable to third countries. In the long term, a possible solution for all the above-mentioned problems such as conflict between CCCTB rules and third country tax treaty provisions could be the replacement of the tax treaties of CCCTB-Member States with third countries by one tax treaty to be concluded between every third country and all CCCTB-Member States. This Multilateral tax treaty can be based on the OECD Model after amending the provisions that borrowed from the OECD Model to fit with the CCCTB system.<sup>1372</sup> Moreover, agreeing on a common tax system in the EU makes it the best potential area for conclusion of a multilateral tax treaty.<sup>1373</sup> Taking this action is similar to the outcome of operating a custom union, under which a group of independent countries at the international level act as one tax imposing body, whereas the proposed water's edge system resembles more a free trade area.<sup>1374</sup>

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<sup>1370</sup> Art. 81(3) of the CCCTB Directive.

<sup>1371</sup> For similar analysis on the interaction between Thin capitalisation rules and Non-discrimination Provision in Tax Treaties see Otmar Thoemmes, Robert Stricof and Katja Nakhai, 'Thin Capitalisation Rules and Non-Discrimination Principle', *Intertax*, Vol. 32, No.3, 2004, pp. 126-137.

<sup>1372</sup> For the advantages of the Multilateral tax treaty see Victor Thuronyi, 'International Tax Corporation and a Multilateral Treaty' *Brooklyn Journal of International Law*, Vol.26, 2001, p.1641 at 1644.

<sup>1373</sup> Paul R. McDaniel, 'Colloquium on NAFTA and Tradition: Formulary Taxation in the North American Free Trade Zone', *New York University School of Law Tax Law Review*, Vol. 49, pp. 691,698.

<sup>1374</sup> Stefan Mayor, *Formulary Apportionment for the Internal Market* (IBDF 2009), p.260.

## 5.6 Conclusion

This chapter examined the influence of the international CCCTB taxation rules on the OECD-based tax treaties concluded between the CCCTB-Member States and third countries. It is established that the arm's length concept provided in the CCCTB Directive, which is applicable only in relation to third countries, would raise complexity and cause high compliance costs: firstly as the CCCTB Directive does not provide for common transfer pricing rules. Secondly due the coexistence of the arm's length concept and the CCCTB-Formulary apportionment that apply only within the EU boundaries. It is found that imposing withholding tax on payments made by foreign-based subsidiaries to a third-country parent company at ordinary tax rate (non-tax treaty rate) is in breach of treaty provisions equivalent to Art.10 (2), Art.11 (2) and Art.12 (1) of the OECD Model. Moreover, allocating income to an EU-permanent establishment owned by a third country on the basis of formulary apportionment is in breach of Art. 7 (2) of the OECD. In addition, tax-sparing clause existing in the tax treaties concluded between the CCCTB-Member States and developing third countries would be problematic in respect to the apportionment of the 'fictitious' credit and it contravenes the CCCTB's switch-over clauses. As regards inbound payments, it is evident that exempting foreign permanent establishment income is in line with Art. 7 of the OECD. However, the exemption of dividends received from third countries is contrary to Arts. 10 (1, 2) and 23 A (2) OECD Model.

This chapter showed that the CCCTB's CFC rules are consistent with Arts. 7 and 10 of the OECD, but its application towards third countries results in an international judicial double taxation. This chapter also proved that the CCCTB's thin capitalisation rules are not consistent with the arm's length principle and are undoubtedly in breach of Art. 9 (1) of the OECD Model, and it can be regarded as discriminatory according to Art. 24 (4) of the OECD Model. To do away with all the above incompatibility between the CCCTB rules and third country tax treaties, this chapter suggested the replacement of the tax treaties between CCCTB-Member States and third countries by one tax treaty to be concluded between every third country and all CCCTB-Member States.

## **6 The impact of the CCCTB Provisions on Corporate Tax Practice in Egypt**

### **6.1 Introduction**

The preceding chapters have examined the interaction between the international aspects of the CCCTB and third countries corporate tax practice generally. In order to explore this interaction in practical terms a case study will be included in respect of a third country with close geographical and economic ties to the EU. This country is Egypt. The reciprocal relationship between Egypt and the EU has a relatively long history, and has currently reached an advanced level. Within the framework of the Euro-Mediterranean Partnership (EMP), Egypt has concluded an Association Agreement (AA) with the Member States of the European Union. There is an Action Plan between Egypt and the EU with the aim of achieving the Association Agreement's objectives and provisions. As a result of these accords, the volume of trade and FDI between Egypt and the EU has significantly increased in the last few years.<sup>1375</sup> Moreover, there is a network of bilateral treaties between Egypt and EU Member States on the elimination of double taxation.

The very close relationship between Egypt and the Member States of the EU, especially in respect of trade, FDI and double tax treaties should encourage Egypt to pay attention to the very significant potential impact of the EU-CCCTB system on its businesses. The CCCTB system may not simplify taxation for Egyptian companies operating in Europe, though the objective of the CCCTB is to reduce the compliance burden for companies, and it may affect the European FDI flow into Egypt. This is likely to exist as a result of the interaction between the CCCTB-formulary apportionment and Egypt's transfer pricing rules. The CCCTB rules may also conflict with provisions of current Egypt tax treaties with EU-Member States, such as provision on the elimination of double taxation, taxation of business income, the definition of permanent establishment, and taxation of dividends, interest and royalties.

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<sup>1375</sup> For detailed figures see sections 6.2.4 and 6.2.5.

This chapter mainly examines the potential impact of the CCCTB provisions which might influence corporate tax practice in Egypt, i.e. how Egypt's corporate tax rules (both domestic law and treaty-based rules) accommodate the CCCTB provisions, which have cross-border application. The answer to this question involves examining the potential conflict between the CCCTB rules and the Egyptian tax system in respect of residence definition, taxation rules of inbound and outbound income, and methods of elimination of double taxation. However, before proceeding to answer the above question, it is important to evaluate the Egypt-EU relationship in terms of trade, FDI and number of double tax treaties between the two parties. Answering this question also involves a discussion of the main structures of the Egyptian tax system. For the purposes of the overall analysis, therefore, this chapter is divided into three main sections: the EU-Egypt relationship, the main structures of the Egyptian tax system and the impact of the CCCTB provisions on Egypt's corporate tax practice. This chapter argues that the CCCTB system is likely to conflict with certain Egyptian international taxation rules, but it can operate in relation to Egypt at least in the short-term.

## **6.2 The relationship between the EU and Egypt in terms of investment, trade and tax treaties**

Since its very foundation, the European Economic Community (EEC) has had close relations, particularly in the 1960s, with a number of Southern Mediterranean countries such as Morocco, Tunisia, Algeria, Turkey, Egypt and Lebanon. Nevertheless, the Community did not apply a definite policy towards the Mediterranean countries.<sup>1376</sup> In order to have organised relations with these countries, the EEC held its Paris Summit in 1972, and presented its Global Mediterranean Policy (GMP) with the aim of facilitating trade in industrial goods and reducing custom duties on a number of agricultural products. The territorial scope of the GMP covered coastal countries of the southern Mediterranean and Jordan with whom new bilateral agreements had been concluded. The ECC concluded bilateral GMP agreements with Morocco, Algeria and Tunisia in 1976, then with Egypt, Jordan, Lebanon and Syria in 1977.<sup>1377</sup>

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<sup>1376</sup> Sven Biscop, *Euro-Mediterranean Security: A Search for Partnership* (England: Ashgate Publishing Limited, 2003), p.23.

<sup>1377</sup> The GMP was accompanied with 'financial protocols providing for loans and grants from Community budget', see Sven Biscop, *Euro-Mediterranean Security: A Search for Partnership* (England: Ashgate Publishing Limited, 2003), pp.24-25



In the late 1980s, the EEC realised the need to revamp its relations with the Mediterranean region. This was not only due to the growing awareness of the importance of the southern Mediterranean countries to the Community; it is a market for the European products and a source of energy supply to Europe, thus the political stability in the Mediterranean region was important for the security of the Community. However, it was also due to the fact that the GMP scope was mainly limited to economic matters and development cooperation, and although the economic support would lead to stability the economic achievements under the GMP were not satisfactory.<sup>1378</sup>

In subsequent years, the Community proposed several schemes with the aim of taking its relations with the Mediterranean region to a higher level: for instance in 1989 the European Commission proposed a Renovated Mediterranean Policy (RMP), which was launched in 1990.<sup>1379</sup> However, like the GMP, the RMP failed to resolve the socio-economic and security problems of the Mediterranean.<sup>1380</sup>

In 1990, other attempts such as the Conference on Security and Co-operation in Europe (CSCE) and the Arab-Maghreb Union (AMU) were made, for the reorientation of the European policy towards the Mediterranean.<sup>1381</sup> These attempts led the European Commission to propose the creation of the Euro-Mediterranean Association, which was approved by the European Council in 1994.<sup>1382</sup> Subsequently, in November 1995, the EU Member States and the Mediterranean countries issued the Euro-Mediterranean Partnership (EMP) with a wider scope than the previous schemes. This was also known as the Barcelona Process.<sup>1383</sup>

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<sup>1378</sup> Sven Biscop, *Euro-Mediterranean Security: A Search for Partnership* (England: Ashgate Publishing Limited, 2003), pp.24-25.

<sup>1379</sup> The RMP included 'a substantial increase in the financial assistance to the Mediterranean countries, an important instauration when compared to GMP was 'horizontal cooperation: multilateral aid programmes with the aim of promoting regional integration in field of common interests, in order to increase regional integration among Arab states, which was at a very low level', see *Ibid*, p.26.

<sup>1380</sup> *Ibid*.

<sup>1381</sup> Arie Bloed (ed.) *The Conference on Security and Cooperation in Europe: Analysis and Basic Documents, 1972-1993 Part 1*(London: Kluwer Academic Publishers, 1993), p.87.

<sup>1382</sup> Ricardo Gomez, *Negotiating the Euro-Mediterranean Partnership: Strategic Action in EU Foreign Policy* (England: Ashgate Publishing Limited, 2003), p.53.

<sup>1383</sup> Sven Biscop, *Euro-Mediterranean Security: A Search for Partnership* (England: Ashgate Publishing Limited, 2003), p.26.

The EMP established a new regional relationship and this was a milestone in Euro-Mediterranean relations. The Partnership had three essential objectives. Firstly, the establishment of a profound Euro-Mediterranean Free Trade Area, thereby abolishing barriers to trade and investment between both the EU and Southern Mediterranean countries and between the Southern Mediterranean countries themselves. Secondly, the creation of a common area of peace and stability through improved dialogue between the two parties at political and security levels. Lastly, the contribution by the EMP to the development of social and cultural relations between both sides by exchanges between their civil societies.<sup>1384</sup>

The EU-Southern Mediterranean relations at the bilateral level are managed mainly by the Euro-Mediterranean Association Agreements. Almost all countries have concluded bilateral Association Agreements with the EU.<sup>1385</sup> Currently, countries which have bilateral EMP Association Agreements in force with the EU are Algeria, Tunisia, Morocco, Lebanon, Egypt and Israel and Palestine.<sup>1386</sup>

In 2004, the European Union launched the European Neighbourhood Policy (ENP) within which the EU provides its neighbours with a privileged relationship, building upon a reciprocal commitment to shared values.<sup>1387</sup> These values include democracy and human rights, lawfulness, decent governance, market economy principles and sustainable development.<sup>1388</sup> The ENP offers political association and deeper economic integration, increased mobility and more social communication. A key objective of the ENP is to establish bilateral Action Plans between the EU and each ENP partner. Action plans set out a schedule of political and economic reforms with short and medium-term priorities of 3 to 5 years. Twelve countries of the southern Mediterranean countries are signatories to the ENP, but Algeria, Libya and Syria have not fully adopted the ENP as

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<sup>1384</sup> See <<http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/euromed/>> accessed 10 January 2013.

<sup>1385</sup> Since the conclusion of EMP, the trade relations between Southern Mediterranean countries themselves are evolving; Tunisia, Morocco, Jordan, and Egypt have concluded The Agadir Agreement since 2007 and it is available for more Arab countries to join in. Additionally, Egypt, Israel, Morocco, the Palestinian Territories, Syria and Tunisia have signed bilateral agreements with Turkey. Also, Israel and Jordan have signed a Free Trade Agreement. See <<http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/euromed/>> accessed 15 January 2013.

<sup>1386</sup> See <<http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/euromed/>> accessed 10 January 2013

<sup>1387</sup> European Commission, 'Wider Europe—Neighbourhood: A new framework for relations with our Eastern and southern neighbours', COM (2003) 104 final, p. 4.

<sup>1388</sup> See <[http://ec.europa.eu/world/enp/policy\\_en.htm](http://ec.europa.eu/world/enp/policy_en.htm)> accessed 15 December 2012.

they do not have agreed Action Plans. The ENP builds upon existing agreements, such as Co-operation Agreements or Association Agreements, between the EU and the respective country. Monitoring and promotion of the ENP implementation is jointly assigned to the Committees and sub-Committees established in the frame of the agreement in question.<sup>1389</sup>

### 6.2.1 Egypt-EU relations

Although Egypt is not a large oil exporter like other Arab countries, it is a crucial country in the Middle East and North Africa.<sup>1390</sup> It is the largest country in the region; it plays a strategic role in the Middle East and North Africa (MENA), and it also has a potentially prosperous economy, which is not used to great advantage.<sup>1391</sup> Egypt not only leads the Arab League and the Arab voice in the world, but is also actively concerned with African issues.<sup>1392</sup> Due to the proximity of the Middle East and North Africa (MENA) to Europe, it has been regarded as the backyard of the European region.<sup>1393</sup> Any instability in the economic, political and social issues in MENA could negatively involve the economic and security aspects of the EU, and thus in order to effectively manage the relations with MENA including Egypt, the EU has laid down instruments such as the EMP and ENP as outlined above.<sup>1394</sup>

The official relationship between the European Union and Egypt dates back to 1966 when Egypt and the European Community first established diplomatic relations.<sup>1395</sup> The first Co-operation Agreement between the two sides was signed in 1972 and came into

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<sup>1389</sup> For more on the ENP see Karen E. Smith, 'The outsiders: The European Neighbourhood Policy', *International Affairs*, Vol. 81, No.4, 2005, pp.757-773.

<sup>1390</sup> Michele Comelli, 'Dynamics and Evolution of the EU-Egypt Relationship within the ENP Framework', *Istituto Affari Internazionali*, (2010) *Document IAI 10 / 02*, p.5.

<sup>1391</sup> *Ibid*, p.6.

<sup>1392</sup> Egypt: country strategy Paper 2007-2013 available at

<[http://ec.europa.eu/world/enp/pdf/country/enpi\\_csp\\_egypt\\_en.pdf](http://ec.europa.eu/world/enp/pdf/country/enpi_csp_egypt_en.pdf)> accessed 1 January 2013.

<sup>1393</sup> Shaista Shaheen Zafar, 'Contemporary EU-Egypt Relations within the Parameters of the EU's Euro-Mediterranean Partnership programme and ENP', *Journal of European Union Studies*, 2011, pp.98-118, at 19. Available at <SSRN: <http://ssrn.com/abstract=1798262>> accessed 15 November 2012.

<sup>1394</sup> Michele Comelli, 'Dynamics and Evolution of the EU-Egypt Relationship within the ENP Framework', *Istituto Affari Internazionali*, (2010) *Document IAI 10 / 02*, p.5.

<sup>1395</sup> European Neighbourhood and Partnership Instrument, Arab Republic of Egypt National Indicative Programme. 2011-2013 at <[ec.europa.eu/world/enp/pdf/country/2011\\_enpi\\_nip\\_egypt\\_en.pdf](http://ec.europa.eu/world/enp/pdf/country/2011_enpi_nip_egypt_en.pdf)> accessed 15 December 2012.

force in 1973.<sup>1396</sup> In March 1977, this agreement was replaced with a wider scope one, which was in the frame of the Community's joint policy. Under its provisions, Egypt enjoyed free market access for its industrial exports to the EU, while EU exports of industrial products enjoyed the Most Favoured Nation (MFN) Treatment.<sup>1397</sup> For agriculture, under the 1987 Protocol, Egypt enjoyed preferential treatment in access to the EU market by means of tariff quotas and export calendars for its traditional flows. EU exports of agricultural products take place under the MFN treatment. In the framework of the economic cooperation under the Co-operation Agreement, four financial protocols stipulated that the Community should finance Egypt for programs and projects until 1996.<sup>1398</sup> As discussed above these pacts covered trade, economic, technical and financial aspects.<sup>1399</sup> The Egypt-EU relationship was taken to a deeper level by the EMP and the related AA, which established a wider and more comprehensive legal agenda for the economic, political and social aspects of the relationship between the EU and Egypt.<sup>1400</sup>

As time went by, the regional and international context of Egypt-EU relations developed a greater scope for cooperation. On the one hand, the enlargement of the EU on 1 May 2004, which was a crucial advancing move for the EU from a political, geographic and economic perspective, facilitated the initiation of the European Neighbourhood Policy.<sup>1401</sup> On the other hand, Egypt has vigorously continued to follow its external policy with the objective of strengthening its relations with outsiders, particularly with the EU. Egypt is committed to becoming further integrated into the worldwide economy, and to modernizing its economy and policies. Thus, a major opportunity has surfaced for Egypt and the EU to strengthen further their strategic

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<sup>1396</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 13 December 2011.

<sup>1397</sup> *Ibid.*

<sup>1398</sup> *Ibid.*

<sup>1399</sup> Emad Gad, 'Egyptian-European Relations: From Conflict to Cooperation', in Gerd Nonneman (ed.) *Analysing Middle East Foreign Policy and the Relationship with Europe* (Routledge, 2005), pp.64-85 at 77.

<sup>1400</sup> See the Association Agreement between Egypt and the EU at <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 15 December 2011

<sup>1401</sup> European Commission, 'European Neighbourhood Policy: Country Report, Egypt', COM (2005) 72 final, p.2

partnership through a progressively close and heightened cooperation, that is, the ENP.<sup>1402</sup>

Under the ENP, the EU – as it does with all other countries under the ENP – bases its relations with Egypt on respect for Egypt’s identity and works in cooperation with it to improve and renovate all aspects of the latter’s society and economy. The ENP involves a substantial level of economic integration and developing of political, cultural and social cooperation, as well as the promotion of peace, stability, security, growth, development and prosperity in the Euro-Mediterranean region including Egypt.<sup>1403</sup>

The ENP action plan provides a common agenda for developing relations between the EU and its neighbours like Egypt. It is an essential source for determining the EU’s strategic tactic towards a key partner such as Egypt. The ENP secures compatibility between priorities in collective cooperation and other fundamental EU policies.<sup>1404</sup>

### **6.2.2 Egypt-EU Association Agreement (AA)**

The AA between Egypt and the EU was signed in Luxembourg on 25 June 2001. After ratification by the Egyptian People’s Assembly and the European Union Member States it became effective on 1 June 2004. Negotiations between the EU and Egypt for the conclusion of this agreement started in 1995 and lasted more than four years.<sup>1405</sup> The AA is the legal framework guiding relations between Egypt and the European Union. It contains provisions with respect to the three pillars of the EMP: political dialogue, trade and economic integration, and social and cultural cooperation.<sup>1406</sup>

The main objective of the Egypt-EU AA is the creation of a Free Trade Area between the two parties. This implies that tariffs on industrial and agricultural products will be

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<sup>1402</sup> European Commission, European Neighbourhood Policy: Country Report, Egypt’, COM (2005) 72 final, p.2

<sup>1403</sup> *Ibid*, p.3.

<sup>1404</sup> Egypt: country strategy Paper 2007-2013 available at <[http://ec.europa.eu/world/enp/pdf/country/enpi\\_csp\\_egypt\\_en.pdf](http://ec.europa.eu/world/enp/pdf/country/enpi_csp_egypt_en.pdf)> accessed 15 December 2012.

<sup>1405</sup> See the Association Agreement between Egypt and the EU at <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 15 December 2011.

<sup>1406</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39.

dismantled.<sup>1407</sup> The EU-Egypt AA contains provisions for freeing trade in industrial goods, and provisions for facilitating trade in agricultural products. It also provides the opportunity for further liberalisation of trade in services, and farm goods.<sup>1408</sup> Accordingly, an agreement aiming at a further liberalisation of processed agricultural and fishery products was concluded in 2010, and negotiations on liberalisation of services are in progress.<sup>1409</sup> As Egypt is a developing country, it is given an asymmetrical treatment in respect to the abolition of tariffs; the EU has accorded a full dismantling of customs duties and quotas for Egyptian industrial products and for certain agricultural products imported by the EU. In contrast, Egypt is gradually eliminating customs duties for European industrial products and some agricultural products up until 2019.<sup>1410</sup>

The AA also incorporates chapters on services rendering, capital movements and defrayal, provisions on competition rules, protection of intellectual property rights, transparency of public aid, liberalization of public procurement, provisions on state monopolies of a commercial character and the strengthening of economic cooperation on the widest possible basis.<sup>1411</sup>

Under the AA, both parties would deepen their Economic cooperation, namely in respect to education and training, science and technology, environment, industrial cooperation, investment promotion, standardization and conformity assessment, approximation of laws, financial services, agriculture and fisheries, transport, information society and telecommunications, energy, tourism, customs statistics, money laundering, fight against drugs and terrorism, consumer protection and regional cooperation.<sup>1412</sup>

Moreover, according to the AA, cooperation should be intensified regarding social and cultural issues. A dialogue on social issues will be held in respect to the movement of

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<sup>1407</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Chapter 1 and 2.

<sup>1408</sup> *Ibid.*

<sup>1409</sup> EU-Egypt Agreement on agricultural, processed agricultural, fish and fishery products[2010] OJ L 106/41, p.41.

<sup>1410</sup> See the Association Agreement between Egypt and the EU at <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/political\\_relations/agreements/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/political_relations/agreements/index_en.htm)> accessed 15 December 2011.

<sup>1411</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Title III and IV.

<sup>1412</sup> *Ibid.*, Title V.

workers, migration matters, intercultural dialogue and social integration of Egyptian and Community nationals legally residing in the territories of their host countries.<sup>1413</sup> Cooperation is also foreseen for the elimination and control of illegal immigration and other consular issues, whereby EU Member States and Egypt agree to negotiate and conclude bilateral agreements with each other, organizing specific obligations for the readmission of their nationals. Cooperation is similarly predicted on cultural matters, audiovisuals, media and information.<sup>1414</sup>

### **6.2.3 The Action Plan for the EU-Egypt Association Agreement**

The Joint Action Plan between Egypt and the EU was formally adopted at the EU/Egypt Association Council in Brussels on 6 March 2007. The Joint Action Plan brings Egypt into the series of partnerships set up under the European Neighbourhood Policy (ENP), aimed at strengthening relations and bringing about greater stability and prosperity, based on mutual interest and nationally determined priorities. Relations between Egypt and the EU have been structured on the political and economic components of the EU/Egypt Association Agreement.<sup>1415</sup>

This Action Plan is a primary phase in a process covering a time frame of three to five years. The objective of implementing the Action Plan is to help in achieving the aims and provisions of the AA, and to encourage and support Egypt's domestic development, renovation and reform objectives. It also facilitates developing and enforcing policies and arrangements that aim at the promotion of economic growth, employment and social cohesiveness.<sup>1416</sup>

The application of the Action Plan will also help, where relevant, further integration into European Union economic, social and technological structures and significantly increase the possibility to progress the approximation of Egyptian legislation and

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<sup>1413</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Title VI.

<sup>1414</sup> *Ibid.*

<sup>1415</sup> EU and Egypt action plan at < <http://trade.ec.europa.eu/doclib/html/146097.htm> > accessed 15 December 2012.

<sup>1416</sup> *Ibid.*

standards to those of the European Union in appropriate areas, and thus opportunities for trade, investment and growth would be enhanced.<sup>1417</sup>

The Action Plan determines a comprehensive set of important priorities in areas covered by the AA. These areas include the enhancement of economic integration with the EU by taking steps towards the continuing liberalization of trade in services, and the right of establishment and free trade in agriculture as well as the reforming of the tax system, upgrading public finance management, and improving public institutions.<sup>1418</sup> These areas of priorities that are set out in the action plan would indicate to what extent the relationship between Egypt and the EU will be moving ahead.

As regards taxation, the action plan prioritizes supporting a tax strategy for the innovation and simplification of tax administration. It will also determine the required administrative structures and measures, including a fiscal control strategy, audit and investigation approaches, cooperation with the taxpayers and tax compliance.<sup>1419</sup> The action plan encourages current Egyptian attempts to accomplish the network of bilateral treaties between Egypt and EU Member States on the elimination of double taxation, including the enhancement of transparency and the exchange of information in accordance with international norms.<sup>1420</sup>

Moreover, the action plan supports the Egyptian efforts to renovate and improve the current General Sales Tax system (GST); switching from GST to a standard VAT system in the medium term is necessary.<sup>1421</sup> Furthermore, it encourages the commencement of a dialogue on international and EU tax standards including the principles relating to transparency and exchange of information for tax purposes and to OECD principles on harmful tax practices.<sup>1422</sup> In any case, cooperation and measures taken under the action plan should be compatible with domestic laws and legislations. Normally, the progress of the action plan implementation is jointly assessed by a sub-committee established within the framework of the AA. Consequently, the EU and

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<sup>1417</sup> EU and Egypt action plan at <<http://trade.ec.europa.eu/doclib/html/146097.htm>> accessed 10 January 2013.

<sup>1418</sup> *Ibid.*

<sup>1419</sup> *Ibid.*

<sup>1420</sup> *Ibid.*

<sup>1421</sup> *Ibid.*

<sup>1422</sup> *Ibid.*



Egypt are reviewing the content of the action plan and deciding on its adaptation and renewal.<sup>1423</sup>

#### **6.2.4 Trade between Egypt and the EU**

Egypt is part of the EMP process, which makes the Mediterranean region a free trade area.<sup>1424</sup> Egypt is a leading trading partner for the EU in the Southern Mediterranean region, and the EU is the principal trading partner of Egypt. Egypt has also been a member of the World Trade Organization (WTO) since 1995.<sup>1425</sup> The trade dealings between Egypt and the EU are ruled by the AA, under which both parties are committed to free trade between them with the elimination of tariffs on industrial products and significant concessions on agricultural products.<sup>1426</sup> Consequently, since the AA came into force in 2004, the EU and Egypt have made significant progress in freeing up trade between them.<sup>1427</sup> According to a number of schedules provided in the AA, Egyptian industrial products are imported into the EU duty-free. Equally, Egyptian tariffs on industrial products which are exported from the EU are being steadily abolished; the abolition process is expected to be accomplished by 2019.<sup>1428</sup>

Moreover, as regards agricultural products, the AA provisions concerning reciprocal liberalisation of trade in agricultural, fisheries and processed agricultural products were subject to amendment in 2010. According to these amendments, most of the exchanges in respect to the agricultural products have been completely liberalized in both directions.<sup>1429</sup> Furthermore, in 2010, the EU and Egypt signed a protocol laying down a dispute settlement mechanism to be applied to disputes under the trade provisions of the

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<sup>1423</sup> For the progress on the implementation of the Action plan in 2009, see European Commission, 'Taking a stock of the European Neighbourhood Policy (ENP), implementation of the European Neighbourhood Policy in 2009, Progress report of Egypt', SEC(2010)517.

<sup>1424</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Art.1.

<sup>1425</sup> See EU-Egypt trade relations at

<[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 10 December 2012.

<sup>1426</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Art.1.

<sup>1427</sup> See EU-Egypt trade relations at

<[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 10 December 2012.

<sup>1428</sup> Egypt-EU Euro-Mediterranean Agreement [2004] OJ L 304/39, Arts. 6 and 9.

<sup>1429</sup> EU-Egypt Agreement on agricultural, processed agricultural, fish and fishery products[2010] OJ L 106/41, p.41.

AA; this Protocol aims at avoiding or settling any trade dispute between Egypt and the EU so as to arrive at a possible mutual solution.<sup>1430</sup>

Additionally, in response to the Egyptian revolution of 25 January 2011, the European Commission ambitiously intends to enhance the progressive economic integration of Egypt as a South-Mediterranean partner into the EU single market.<sup>1431</sup> Accordingly, in order to achieve this objective, on 14 December 2011, the Council of the European Union gave the European Commission the permission to commence preparing negotiations for *Deep and Comprehensive Free-Trade Agreements* (DCFTAs) with Egypt along with other South-Mediterranean partners such as Tunisia, Morocco and Jordan.<sup>1432</sup>

Since 2004, the EU-Egypt bilateral trade has been steadily increasing: it has more than doubled, and peaked in 2011 (from €11.5 billion in 2004 to €23.3 billion in 2011).<sup>1433</sup> The EU-Egypt trade volume was €11.5 billion in 2004, and then increased to €13.3 billion in 2005, €16.8 billion in 2006, and an estimated amount of €17.3 in 2007. The total trade between the EU and Egypt reached €20.9 billion in 2008. Although, on account of the impact of the global slowdown, total EU-Egypt bilateral trade volume contracted by almost 10% in 2009, in 2010 it reached €22 billion, and as mentioned, the highest level of bilateral Egypt-EU trade was in 2011 (€23.3 billion).<sup>1434</sup>

### **6.2.5 Egypt-EU Foreign Direct Investment (FDI)**

In general, the business climate has improved in Egypt as constant efforts have been undertaken. In this respect, one achievement is that the General Authority for Investment (GAFI) created a ‘one-stop-shop’ for investors. The improvement in the business climate was reflected in the ‘Doing Business 2011 rankings of the World

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<sup>1430</sup> Protocol between the European Union and the Arab Republic of Egypt establishing a dispute settlement mechanism applicable to disputes under the trade provisions of Association Agreement [2011] OJ L 138/3, p. 3.

<sup>1431</sup> See EU-Egypt trade relations at <[http://eas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/index\\_en.htm](http://eas.europa.eu/delegations/egypt/eu_egypt/trade_relation/index_en.htm)> accessed 10 December 2012.

<sup>1432</sup> *Ibid.*

<sup>1433</sup> See <[http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc\\_113375.pdf](http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113375.pdf)> accessed 15 January 2012.

<sup>1434</sup> *Ibid.*

Bank'.<sup>1435</sup> According to this ranking, Egypt has advanced five levels, from 99<sup>th</sup> to 94<sup>th</sup>, of 183 world economies. Nonetheless, according to the 2012 ranking, Egypt has gone back two levels (from 108<sup>th</sup> to 110<sup>th</sup> out of 183). Yet Egypt is considered one of the leading performers with respect to starting a business. Conversely, dealing with construction licences and implementing contracts remain critical areas, impacted by long delays, complicated procedures, and ineffective administration.<sup>1436</sup>

Egypt is the first Arab country to sign the OECD's Declaration on International Investment (2007), under which Egypt is committed to providing national treatment to foreign investors and to promoting responsible international business conduct.<sup>1437</sup> However, at present Egypt exceptionally does not provide 'national treatment for foreign investors' in a number of sectors, such as construction, maritime and air transportation, courier services, commercial agency services, and government procurement: public monopolies operate in fixed line telecommunications, electricity production and distribution, gas distribution, railway transportation and postal delivery services. Additionally, Egypt restricts the number of foreign employees in a company to a maximum of 10% of the total number of employees.<sup>1438</sup>

Foreign investment in Egypt is mainly ruled by the Investment Law No. 94 of 2005. Nevertheless, the Companies Law 159/1981 applies to other sectors that do not fall under the ambit of the Investment Law. The GAFI is the main authority in charge of the registration, facilitation and promotion of investment.<sup>1439</sup>

Amongst the 69 Bilateral Investment Treaties (BITs)<sup>1440</sup> concluded between Egypt and different countries around the world, more than 22 have been concluded with most of

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<sup>1435</sup> Doing Business Reports of the World Bank is available at <<http://www.doingbusiness.org/>> accessed 11 January 2012.

<sup>1436</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/investment/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/investment/index_en.htm)> accessed 10 December 2012.

<sup>1437</sup> See OECD Declaration and Decisions on International Investment and Multinational Enterprises at <<http://www.oecd.org/daf/internationalinvestment/investmentpolicy/oecddeclarationanddecisions.htm>> accessed 10 January 2013.

<sup>1438</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/investment/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/investment/index_en.htm)> accessed 11 January 2013.

<sup>1439</sup> *Ibid.*

<sup>1440</sup> Bilateral investment treaties (BITs) are agreements between two countries for the mutual encouragement, promotion and protection of investment in each other territories by companies based in either country. treaties normally contain the following areas : scope and definition of the investment ,admission and establishment , domestic treatment, most favoured treatment , fair and equitable treatment

the EU countries.<sup>1441</sup> These treaties will normally continue in force unless terminated by the two parties or replaced by a new agreement on behalf of the EU. The objective of the provisions of these treaties is to reciprocally promote and protect foreign investment and typically to provide for investor-State international dispute settlement mechanisms.<sup>1442</sup>

As regards the volume of foreign investment in Egypt, Egypt is the number one recipient of FDI in the Southern Mediterranean region, with \$ 6.7 billion net FDI inflows attracted in 2009 and \$ 6.3 in 2010.<sup>1443</sup> The leading sector is oil and gas, which constitutes the majority of the country's FDI. However, in 2011, for the first time ever recorded, net FDI inflows to Egypt were negative (\$ -482 million). This was due to the political instability of the transition period, which had a harsh effect on Egypt's attractiveness for FDI.<sup>1444</sup>

In terms of the EU and Egypt's FDI, the EU is the top investor in Egypt. In 2011/2012 more than 80% of the total inflow of FDI originated in the EU compared to 60% in 2010. The most important EU-Member States investing in Egypt, particularly during the last decade, are the UK, Belgium, France and Italy.<sup>1445</sup> After the January 25 Egyptian Revolution, due to the decline in the security level, and to political instability and social unrest, EU companies established in Egypt have had to face several difficulties which negatively affect investors, such as cumulative payment arrears, demand decline particularly in tourism, and the automotive and cement industries, postponements in international transfers and legal uncertainty regarding earlier contracts. Yet EU company investments are sustained in Egypt as these challenges are seen as impermanent. Moreover, during the financial year 2011/2012, the EU was the only

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, compensation in the event of expropriation or damage to the investment , guarantee of free transfer of funds, and dispute settlement mechanism, both State to State and investor- State .

<sup>1441</sup> These countries include Albania; Austria; Belarus; Belgium; Bulgaria; Cyprus; Czech Republic; Denmark; Finland; France; Greece; Italy; Latvia; Malta; Netherlands; Poland; Portugal; Romania; Russian Federation; Slovakia; Slovenia; Spain; Sweden; Switzerland; Ukraine; United Kingdom. Source: GAFI (General Authority for Investment and free Zones).

<sup>1442</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/investment/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/investment/index_en.htm) > accessed 11 January 2012.

<sup>1443</sup> Source: UNCTAD, World Investment Report 2012at <<http://unctad.org/SearchCenter/Pages/Results.aspx?k=Egypt%20FDI>> accessed 12 January 2013.

<sup>1444</sup> *Ibid.*

<sup>1445</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/investment/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/investment/index_en.htm) > accessed 11 January 2012.

source that increased its FDI flows to Egypt; the EU pumped \$ 9.5 billion gross FDI to Egypt, compared to \$ 6.1 billion in 2010.<sup>1446</sup>

Moreover, investment in Egypt and the region is encouraged by the EU, and the European Investment Bank (EIB) provides Egypt with loans, private equity and technical support. For instance, the EIB has mobilized € 22.772 billion so far for the South Mediterranean region; Egypt has been granted the largest part which is € 5,573 billion. In 2010 the financial support to Egypt by the EIB was up to € 906 million in the main sectors such as energy, environment, industry and transport.<sup>1447</sup>

### **6.2.6 Egypt's double tax treaties with the EU-Member States**

Egypt currently has an extensive network of Double Taxation Treaties with about 61 other countries around the world;<sup>1448</sup> nearly all the Arab countries have concluded such treaties with Egypt.<sup>1449</sup> Moreover, there are double tax treaties with Asian countries,<sup>1450</sup> North American countries<sup>1451</sup> and African countries other than the Arab ones.<sup>1452</sup> However, the largest number of Egyptian tax treaties have been concluded with European countries and Member States of the EU.<sup>1453</sup>

It has been argued that the existence of a double tax treaty between two countries does not generally indicate that the volume of trade and investment between these two countries are strong. However, the conclusion of a tax treaty between two contracting states is mainly contingent on the circumstances of the treaty negotiation.<sup>1454</sup>

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<sup>1446</sup> See <[http://eeas.europa.eu/delegations/egypt/eu\\_egypt/trade\\_relation/investment/index\\_en.htm](http://eeas.europa.eu/delegations/egypt/eu_egypt/trade_relation/investment/index_en.htm)> accessed 11 January 2012.

<sup>1447</sup> *Ibid.*

<sup>1448</sup> Source: <<http://www.incometax.gov.eg/treaties.asp>>

<sup>1449</sup> These countries include Algeria, 2001; Bahrain, 1997; CAEU, 1997; Iraq, 1968; Jordan, 1996; Kuwait, 2010; Lebanon, 1996; Libya, 1990; Morocco, 1989; Oman, 2000; Palestine, 1998; Sudan, 1970; Syria, 1991; Tunisia, 1989; UAE, 1994; Yemen, 1997.

<sup>1450</sup> Thailand, 2006; China, 1997; India, 1969; Indonesia, 1998; Japan, 1968; Turkey, 1993

<sup>1451</sup> The USA, 1980; Canada, 1983.

<sup>1452</sup> South Africa, 1997.

<sup>1453</sup> Armenia, 2005; Austria, 1962; Albania, 2002; Belarus, 1998; Belgium, 1991; Bulgaria, 2003; Cyprus, 1993; Czech Republic, 1995; Denmark, 1989; Finland, 1965; France, 1980; Germany, 1987; Greece; Hungary, 1991; Italy, 1979; Malta, 1999; Netherlands, 1999; Norway, 1964; Poland, 1996; Romania, 1979; Russia, 1997; Serbia, 2005; Slovakia, 2004; Slovenia, 2009; Spain, 2005; Sweden, 1994; Switzerland, 1987; Ukraine, 1997; United Kingdom, 1977.

<sup>1454</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.60.

Nonetheless, the significant number of double tax treaties concluded between the EU-Member States and Egypt justifies examining the impact of the CCCTB provisions on Egypt's tax treaties with the EU-Member States. Therefore, in addition to the very close relationship between the European Union and Egypt in terms of FDI, trade and the large number of Egypt-EU double tax treaties would require examining the CCCTB provisions that may have an influence on international corporate tax practice in Egypt. This also postulates a discussion of the main features of the Egyptian tax system, focusing on corporate tax practice in Egypt.

In the following section, the discussion is focused on the essential structures of Egypt's tax system including both direct and indirect taxation. In turn, direct taxation is divided into individual and corporate income tax. As regards corporate taxation, this section addresses the personal scope of company taxation, corporate tax rates, and rules for the calculation of the tax base.

### **6.3 Main structures of Egypt's tax system**

#### **6.3.1 Egypt's taxation policy, objectives and reform**

Taxation has been a fact of Egyptian life throughout history; it was imposed in the Pharaonic Era, then the Romans levied taxation in Egypt, and similarly in Islamic Egypt "Zakat" was a financial obligation as a form of taxation at that time.<sup>1455</sup> When Egypt was part of the Ottoman Empire, various taxes were imposed, as the main resource of Egypt's Treasury.<sup>1456</sup> The first modern tax system, introduced into Egypt in 1939, imposed taxes on mobile capital revenue, commercial and industrial activities and labour gains (Law No. 14 of 1939 and (Law No. 113 of 1939) on agricultural land.<sup>1457</sup> Other taxation laws were issued in subsequent years.<sup>1458</sup> The current tax law is the Income Tax Law, which is promulgated by Law No. 91 of 2005.

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<sup>1455</sup> Ramadan Sydeik, *Income Tax Law* (Dar El Nahdah el Arabia, Cairo, 2007), p.3.

<sup>1456</sup> *Ibid.*

<sup>1457</sup> *Ibid*, p.4.

<sup>1458</sup> These laws include: an urban building tax in 1954 (Law No. 56 of 1954); a customs regime in 1963 (Customs Law No. 66 of 1963); stamp duties in 1980 (Stamp Duties Law No. 111 of 1980); consumption taxes in 1981 (Consumption Tax Law No. 133 of 1981) which in was replaced by the General Sales Tax Law No. 11 of 1991; and a new income tax law in 1981 (Income Tax Law No. 157 of 1981) were introduced. This Income Tax Law was amended in 1993 by Law No. 187 of 1993 (Unified Income Tax).

Egypt is currently reorienting its taxation policy from focusing on targeting revenue collection to meeting budget expenditure and protecting domestic industries. In this respect, the Egyptian government is endeavouring to apply a more proactive policy, which has the objective of promoting the country's competitiveness, as well as broadening trade and investment opportunities for businesses.<sup>1459</sup> Under the most recent income tax law, the Egyptian government has recognised that without a significant structural tax reform, the economic growth in general would be subject to stagnation, unemployment would increase, and investment would be diverted out of Egyptian jurisdiction.<sup>1460</sup> Therefore, Egypt's tax policy and administration were analysed and a set of reforms was developed in order to move the Egyptian tax regime into a modern and appropriate system that can participate in economic growth and attract FDI to Egypt.<sup>1461</sup>

For instance, from the corporate tax perspective, Egypt previously relied on a high tax rate to maintain its revenue base.<sup>1462</sup> However, under the current tax law the corporate tax rate has been significantly reduced to 20%, which is applicable to all commercial and industrial activities.<sup>1463</sup> The corporate tax rate reduction would increase Egypt's competitiveness within the MENA territory as well as with other countries that attract FDI. In addition, it is hoped by the Egyptian government that a strict enforcement system along with the lower tax rate would decrease the incidence of tax evasion.<sup>1464</sup> Furthermore, the current income tax law has introduced the concept of residence-based taxation in respect to corporate taxation<sup>1465</sup> in order to bring the tax system in line with modern international tax practices, and to provide domestic investors with an incentive to invest in Egypt rather than to invest abroad.<sup>1466</sup> The introduction of a residence-based

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<sup>1459</sup> OECD, National Investment Reform Agenda, MENA-OECD investment programme, Egypt, 2005, p.20.

<sup>1460</sup> *Ibid*, p.21.

<sup>1461</sup> *Ibid*.

<sup>1462</sup> Prior to the introduction of the Income tax law No. 91 of 2005, Egypt corporate tax rate stood at 42%, see Income Tax Law No. 187 of 1993.

<sup>1463</sup> Art.49 of the Income tax law No. 91 of 2005

<sup>1464</sup> OECD, National Investment Reform Agenda, MENA-OECD investment programme, Egypt, 2005, p.21.

<sup>1465</sup> Art. 47 (1) of the Income tax law No. 91 of 2005.

<sup>1466</sup> OECD, Business Climate Development Strategy, Egypt, phase 1 policy assessment, dimension 1-3 tax policy, 2010.

taxation which is associated with credits for foreign tax paid abroad would help Egypt to retain its domestic investment.<sup>1467</sup>

Additionally, the income tax law presents a large number of provisions on international taxation as well as several rules on tax base protection to work as a guard against tax planning and to enable the collection of a fair and reasonable share of tax revenue from foreign investment.<sup>1468</sup> These international tax rules include transfer pricing rules, thin capitalisation rules,<sup>1469</sup> definitions of permanent establishment<sup>1470</sup> and royalties.<sup>1471</sup> With regard to tax administration, the new law contains some rules which aim to increase compliance and renovate tax administration as a whole. The law greatly revamps the enforcement of the legal framework, introducing random audits<sup>1472</sup> and high penalties for violators, instead of the previous system of bonuses for inspectors.<sup>1473</sup> In addition, Egypt will make more use of the exchange of information procedures in their double tax treaties to curb aggressive cross-border tax planning.<sup>1474</sup>

As a result of this reform, it is expected that the business climate in Egypt will be significantly improved, and Egypt will have a stable revenue base, as well as a transparent and effective form of policymaking and a more modern and efficient tax administration system.<sup>1475</sup> Although the initiation of the current income tax law is considered to be a significant achievement, several challenges remain in respect to the implementation of the law; among these challenges is the application of the new residence-based system and anti-avoidance rules for corporate taxpayers. For instance, residence-based taxation is much more complicated than the previously applied source-based tax system. This tax reform, which is coupled with sophisticated anti-abuse rules, such as transfer pricing and thin capitalisation rules, will require significant retraining of tax inspectors and outreach and education for corporate taxpayers.<sup>1476</sup>

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<sup>1467</sup> OECD, Business Climate Development Strategy, Egypt, phase 1 policy assessment, dimension 1-3 tax policy, 2010.

<sup>1468</sup> OECD, National Investment Reform Agenda, MENA-OECD investment programme, Egypt, 2005, p.20.

<sup>1469</sup> Art. 52(1) of the Income tax law No. 91 of 2005

<sup>1470</sup> Art. 4 of the Income Tax Law No. 91 of 2005

<sup>1471</sup> Art. 1 of the Income tax law No. 91 of 2005

<sup>1472</sup> See section four, book six of the Income Tax Law No. 91 of 2005

<sup>1473</sup> See book seven of the Income tax law No. 91 of 2005.

<sup>1474</sup> OECD, National Investment Reform Agenda, MENA-OECD investment programme, Egypt, 2005.

<sup>1475</sup> *Ibid.*

<sup>1476</sup> OECD, National Investment Reform Agenda, MENA-OECD investment programme, Egypt, 2005.



### **6.3.2 Egypt's principal taxes**

The current tax system in Egypt contains both direct taxes and indirect taxes.

#### **6.3.2.1 Indirect taxes**

The indirect taxation encompasses General Sales Tax (GST), which was introduced through Law No. 11/1991; Custom Duties under Law No. 66 of the Year 1963 as amended by Law No. 95/2005; Stamp Duties, found in Code No. 143 of 2006 which was issued amending Law No. 111 of 1980.<sup>1477</sup>

#### **6.3.2.2 Direct taxes**

The direct taxes include real estate tax (introduced via Tax Law No. 196 of 2008),<sup>1478</sup> individual income taxes and corporate income taxes. As regards direct taxation, the current income tax law distinguishes between two main categories of taxpayers pursuant to their legal personality: individuals resident in Egypt are subject to personal income tax, and Egyptian legal entities are subject to corporation tax.

##### **6.3.2.2.1 The Individual Income Tax (IIT)**

Natural persons, whether they are non-resident or resident in Egypt, are taxed annually on their total net income sourced within the territory. In other words, the tax law adopts the territoriality principles and imposes tax on the Egyptians and foreigners regardless of whether they are resident or non-resident in Egypt insofar as the income is gained from activities in Egypt. This rule is based on the concept of economic and social nexus.<sup>1479</sup> The taxable income, i.e. the amount to which the tax rate is applied, is the total income derived from four categories of income reduced by the exempted income,<sup>1480</sup> cost and expenses<sup>1481</sup>. In other words, the income tax law recognises four categories of revenues to be included in the individual taxable income. These types of

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<sup>1477</sup> Inheritance tax as an indirect taxation has been abolished by the Egyptian authority in 1997.

<sup>1478</sup> Law no. 118 of 2011 was issued by the Supreme Council of the Armed Forces (SCAF) amending the Real Estate Tax Law No. 196 of 2008, whereby the application of the 2008 Law should have been effective starting from 1 January 2012. From that date, taxpayers were to commence remitting any real estate taxes due. However, the Ministry of Finance has recently confirmed that it intends to make the law effective January 2013, for more detail see, <[www.pwc.com/m1/en/tax](http://www.pwc.com/m1/en/tax)> accessed 7 January 2013.

<sup>1479</sup> Art. 6 of the Income Tax Law No. 91 of 2005.

<sup>1480</sup> Arts. (13)(31)(36)(43) of the Income tax law No. 91 of 2005.

<sup>1481</sup> Art. 23 of the Income tax law No. 91 of 2005.

income revenues are: employment income; business income which includes income from commercial and industrial activities; non-commercial income; and income from real estate.<sup>1482</sup>

The individual is deemed to be resident in Egypt if any of the following criteria are met: firstly, if the natural person has permanent residence in Egypt's territory;<sup>1483</sup> secondly, if the individual resides in Egypt for more than 183 days continuously or intermittently within twelve months; lastly, if an Egyptian resident is working abroad and receiving income from the Egyptian Treasury.<sup>1484</sup>

### **6.3.2.2.2 Corporate income tax**

Corporate income tax is a form of direct tax levied on Egyptian legal entities which are treated as separate taxpayers from the individual taxpayers.<sup>1485</sup> Juristic persons are taxed annually on their net income regardless of their objectives.<sup>1486</sup> The Egyptian legislator distinguishes between resident juristic persons, who are subject to corporate tax on their worldwide income (excluding the Agency of National Service Projects of the Ministry of Defence), and non-resident juristic persons for tax purposes are subject to corporate tax only for income earned in Egypt through a permanent establishment.<sup>1487</sup>

#### **6.3.2.2.2.1 Scope of corporate tax**

For the purposes of corporate income tax calculation, a juristic person includes both corporations and partnerships, including joint stock companies, companies limited by shares, companies with limited liability, and limited partnerships.<sup>1488</sup> These companies are subject to tax irrespective of the law they are subject to or whether they are corporations de facto or not. Banks and foreign companies are also subject to corporate

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<sup>1482</sup> Art. 23 of the Income tax law No. 91 of 2005.

<sup>1483</sup> An individual is considered to have a permanent residence in Egypt where he stays in Egypt for the majority of the year, either in his own property, or as a tenant or in any other place, or when he has a local commercial presence, professional office, industrial site or any other place where he carries on his activities in Egypt, see Art. 3 of the Executive Regulations of the Income Tax Law No. 91 of 2005.

<sup>1484</sup> Art. 2 of the Income tax law No. 91 of 2005.

<sup>1485</sup> Art. 47 of the Income tax law No. 91 of 2005

<sup>1486</sup> *Ibid.*

<sup>1487</sup> *Ibid.*

<sup>1488</sup> Art. 48 of the Income tax law No. 91 of 2005.

tax in Egypt even if their head offices are located abroad and their branches are within the Egyptian territory.<sup>1489</sup>

Moreover, corporate income tax applies to Cooperatives and their unions, the entities that are established by local authorities regarding only their activities which are subject to tax, and the public authorities and other juridical persons with respect to the activities performed by them which are subject to tax.<sup>1490</sup>

The above-mentioned forms of Egyptian corporation, particularly joint stock companies, companies limited by shares, companies with limited liability, cooperatives and their unions, and industrial and commercial public establishments and undertakings, will be eligible to opt for the CCCTB system in respect of their EU-located permanent establishments. This is because these forms are similar to company forms listed in Annex I of the CCCTB Directive, such as companies' forms under French and Luxembourg law, and they are subject to one of the corporate taxes listed in Annex II of the CCCTB Directive, such as 'corporation tax' in the UK and tax on companies (*l'impôt sur les sociétés*) in France.<sup>1491</sup>

#### **6.3.2.2.2.2 Corporate tax rate**

The annual net profits of corporations are taxed at the rate of 20%;<sup>1492</sup> this flat tax rate is applicable to all commercial and industrial activities. However, oil and gas exploration and production corporations are taxed at the rate of 44.55%. In addition, as an exception to the above flat rate, the incomes of the Suez Canal, the Egyptian General Petroleum Corporation and the Egyptian Central Bank are subject to a 40% tax rate.<sup>1493</sup> The European Commission expects that introducing common rules for the calculation of the tax base in the EU would intensify the tax rate competition.<sup>1494</sup> A study in 2011 shows that the effective tax rate on multinationals in the EU will rise as a result of the

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<sup>1489</sup> Art. 48 of the Income tax law No. 91 of 2005.

<sup>1490</sup> *Ibid.*

<sup>1491</sup> Arts. 2 and 3 of the CCCTB Directive.

<sup>1492</sup> The most important achievement of 2005 tax reform was the reduction of the corporate tax rate to 20%, prior to the reform Egypt corporate tax rate stood at 42%.

<sup>1493</sup> Art. 49 of the Income tax law No. 91 of 2005.

<sup>1494</sup> See the CCCTB Directive's Memo, p.12.

CCCTB introduction,<sup>1495</sup> and if it does so, Egypt will need to introduce more reductions in its corporate tax rate in order to be competitive with the EU market.

### **6.3.2.2.3 Taxable income of a company in Egypt**

All profits in Egypt or overseas, of resident Egyptian corporations, irrespective of the location of their activities, are taxable. Corporate income tax is levied annually on the net aggregate profits of companies in either the public or private sector.<sup>1496</sup> A company's fiscal year is the period chosen for its financial statement period; this is the calendar year or another period.<sup>1497</sup>

#### **6.3.2.2.3.1 Computing the tax base**

Net aggregate profit is determined on the basis of income financial statements. Egypt requires companies to draw up their financial statements in accordance with the Egyptian Generally Accepted Accounting and commercial Principles (GAAP).<sup>1498</sup> These principles are altered for tax purposes by certain statutory provisions of tax law which are mainly related to depreciation, provisions, inventory valuation, inter-company transactions and expenses.<sup>1499</sup>

#### ***A 'revenue' method***

Egypt computation rules implement a 'profit and loss' approach instead of a 'balance sheet' approach. Unlike some national tax systems of the EU-Member States,<sup>1500</sup> the taxable profits are not derived from a comparison between the beginning and end of year balances; but rather the focus is placed on a company's profit and loss position. Therefore, the tax base can be defined as revenues less exempt revenues, less deductible expenses needed to realize such income.<sup>1501</sup>

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<sup>1495</sup> Ernst&Young, Common Consolidated Corporate Tax Base: A study on the impact of the Common Consolidated Corporate Tax Base proposals on European business taxpayers, January 2011, p.37 available at <<http://www.ey.com/GL/en/Services/Tax/International-Tax/Staying-up-to-date-with-the-European-Commission-s-Common-Consolidated-Corporate-Tax-Base-proposals>> accessed 14 January 2013.

<sup>1496</sup> Art. 47 of the Income tax law No. 91 of 2005.

<sup>1497</sup> Art. 5 of the Income tax law No. 91 of 2005.

<sup>1498</sup> Art. 17 of the Income tax law No. 91 of 2005.

<sup>1499</sup> *Ibid.*

<sup>1500</sup> See generally Dieter Endres et al, *The Determination of Corporate Taxable Income in the EU Member States* (Kluwer Law International 2007), p.25 et seq.

<sup>1501</sup> Art. 22 of the Income tax law No. 91 of 2005.

### ***Exempt revenues***

Exemption under Egypt tax law includes profits from land reclamation or cultivation and animal husbandry including fisheries for ten years, and profits from novel projects which are funded by the Social Fund for Development for five years from the date of commencing the business or production date.<sup>1502</sup> Furthermore, profits from securities listed on the Egyptian stock exchange market (including interest on bonds), interest on securities, certificates and deposits which are issued by the Central Bank of Egypt, and interest on deposits in Egyptian banks, are also exempt, as are dividends that Egyptian companies receive for their participation in other companies (particularly limited liability, joint-stock companies and partnerships), and profits and dividends from investment securities in unit trusts established according to Law No. 95 of 1992.<sup>1503</sup>

### ***Deductible expenses***

Company profits are taxed after the deduction of all costs and expenses. Nevertheless, the costs and expenses are fully deductible if they are directly incurred by the entity and are necessary for the performance of the entity's activity in Egypt.<sup>1504</sup> Additionally, such expenses must be supported by original documents unless these costs and expenses customarily have no supporting documents.<sup>1505</sup>

The deductible expenses include interest on loans irrespective of their value, but interest paid on loans is not deductible if the interest rate exceeds double the prevailing credit and discount rate announced by the central bank, even if the entities paying the interest are themselves tax exempt.<sup>1506</sup> Deductible expenses also include duties and taxes paid by the company other than income taxes; depreciation and financial penalties which are paid by the taxpayer as a result of his or her contractual liabilities; various types of social insurance payments such as premiums paid by taxpayers to the National Social Insurance Authority in favour of their workers or the company's owners; and premiums paid to private savings and pension funds established according to Private Funds Insurance Law no. 54 of 1975 or Law No. 64 of 1980, provided that the amount paid does not exceed 20% of the total salaries and wages of the workers. Insurance premiums

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<sup>1502</sup> Art. 31 of the Income tax law No. 91 of 2005.

<sup>1503</sup> Art. 50 of the Income tax law No. 91 of 2005.

<sup>1504</sup> Art. 22 of the Income tax law No. 91 of 2005

<sup>1505</sup> *Ibid.*

<sup>1506</sup> Art. 52 of the Income tax law No. 91 of 2005

paid by the taxpayer against his or her disability and death are deductible provided that this amount does not exceed 3000 pounds per annum.<sup>1507</sup>

Deduction costs also include the company's donations to the government and Egyptian non-governmental organizations on condition that the donations do not exceed 10% of the taxpayer's annual net profit.<sup>1508</sup> Nonetheless, these deductible expenses do not take into account certain expenses specified under Articles 24 and 52 of the income tax law.

### ***Depreciation***

Depreciation is deductible for tax purposes and calculated using the Straight-line method. Depreciation rates are based on various types of assets, though they are negotiable with the tax authority. Typically, annual rates are 5% for Buildings, 10% for intangible assets, 50% for computers, 25% for heavy machinery and equipment, and 25% for vehicles, furniture and other tangible assets. Nonetheless, no depreciation applies to tangible assets not subject to wear and tear such as land, fine art, antiques or jewellery and other assets which are by nature are not depreciable.<sup>1509</sup>

Depreciation is allowable only once at a rate of 30% on new machines and equipment in the year they are placed into service, thus normal depreciation is calculated after deducting 30% depreciation on the net value of new assets, provided that accurate books of account are preserved.<sup>1510</sup>

### ***Treatment of losses***

If the final account of a fiscal year is closed at a loss, losses are allowed to be carried forward against future profits for up to five years.<sup>1511</sup>

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<sup>1507</sup> Art. 23 of the Income Tax Law No. 91 of 2005.

<sup>1508</sup> *Ibid.*

<sup>1509</sup> Art. 25 of the Income Tax law No. 91 of 2005.

<sup>1510</sup> Art. 27 of the Income Tax Law No. 91 of 2005.

<sup>1511</sup> Art. 29 of the Income Tax Law No. 91 of 2005.

## **6.4 How Egypt's corporate tax rules fit the international aspects of the CCCTB system**

This section discusses how Egypt's corporate tax rules (both domestic law and treaty-based rules) accommodate the CCCTB rules which are applicable in relation to third countries such as Egypt. It will examine the interaction between the CCCTB and Egyptian tax rules for companies' residency, and the potential conflict between the CCCTB provisions on the elimination of double taxation and Egyptian tax treaties. This section also deals with the interaction between the CCCTB rules and Egypt's international corporate tax system in respect of the taxation of passive income, i.e. interest, dividends and royalties as well as the taxation of permanent establishment. This will be carried out through a discussion of taxation of inbound and outbound payments from Egypt. The interaction between the CCCTB-formulary apportionment and Egyptian transfer pricing is addressed in this section.

### **6.4.1 Tax covered**

One of the preliminary issues which needs to be addressed is whether the taxation imposed under the Egyptian tax law and by participating Member States under the CCCTB system falls within Article 2 of the OECD Model, which concerns the taxes covered by the treaty. Egyptian tax treaties have strictly adopted Article 2 of the OECD Model to determine the material scope of such treaties. This provision stipulates in part:

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its Political subdivisions or local authorities, irrespective of the manner in which they are levied.
3. The existing taxes to which the Convention shall apply are in particular:
  - a) (in State A): .....
  - b) (in State B): .....

As can be observed, the OECD Model does not specify the nature of the taxes which are covered by the tax treaty, thus it is necessary to consult the domestic law of each contracting state to determine the taxes covered. Most Egyptian tax treaties have introduced a simplified method of defining the material scope of the treaty by listing

taxes that were covered by the relevant tax treaty.<sup>1512</sup> Egyptian tax treaties cover income tax, including tax on the income of commercial and industrial activities; tax on income from movable capital and tax on income derived from immovable property; tax on wages and salaries; and tax on profits from liberal professions and all other non-commercial professions. Moreover, the defence tax and the jihad tax are included in the most Egyptian tax agreements as taxes covered by the respective tax treaties, although they do not exist in the domestic tax law anymore.<sup>1513</sup> This implies that such tax conventions need to be updated in this respect. These tax treaties do not explicitly state that ‘corporation tax’ is among the taxes covered by the tax treaty. However, under the domestic tax law of Egypt, corporate tax is considered to be an item in income tax.<sup>1514</sup> In some other Egyptian tax treaties with EU-Member States, ‘corporation income tax’ is explicitly included in the material scope of such tax treaties.<sup>1515</sup>

On the other hand, under the CCCTB system the manner in which the taxable base of group members is determined is fundamentally different from the current practice of EU Member States.<sup>1516</sup> Nonetheless, the change does not extend to the nature of the tax imposed, i.e. the tax remains as a tax on corporate income, and the participating Member States who impose such tax are left free to determine the corporate tax rate that they will apply.<sup>1517</sup> Since the CCCTB system is only concerned with corporate taxation, which falls under the scope of OECD-based tax treaties concluded between Egypt and the vast majority of EU-Member States, Art.2 of the OECD Model does not pose much of a problem to the application of the CCCTB system vis-à-vis Egypt.

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<sup>1512</sup> Commentary to Art. 2(3) OECD Model, 2010, para. 6.1.

<sup>1513</sup> Egypt-EU Member States tax treaties which follow the above approach are, for example, Egypt-France tax treaty (1980) Art. 2(3) (b); Egypt-Italy treaty (1979), Art.2, 3(a), and the tax treaty concluded between Egypt and the United Kingdom (1977) Art.2 (1) (b). Also, Egypt tax treaties with Austria (1962), Romania (1979) and Finland (1965) do not depart from this method of defining the scope of the tax treaty.

<sup>1514</sup> See Book three of Income tax law No. 91 of 2005.

<sup>1515</sup> This can be found, for instance, in the tax treaties between Egypt and Poland(1996), Netherlands(1999), Bulgaria(2003), Greece, Spain (2005), Cyprus1993 (Art.2 (3)(a), Denmark (1989), Belgium(1991), Sweden(1994), Malta(1999), Slovakia(2004), Hungary(1991), Germany(1987).

<sup>1516</sup> Christoph Spengel and York Zollkau (eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income: An International Comparison* (Springer 2012), p.85 et seq.

<sup>1517</sup> Art. 1 of the CCCTB Directive.



#### 6.4.2 Residence and source-based taxation

In relation to the domestic legislation on the residence rules of companies, Egypt imposes a worldwide tax liability upon its residents. The fundamental distinction underlying Egypt's international corporate tax regime is between domestic taxpayers (resident corporations and partnerships), who are taxed on their worldwide income, and foreign taxpayers (non-resident companies), who are taxed only on their Egypt-source income.<sup>1518</sup> Domestic companies have unlimited tax liability, i.e. they are subject to corporate tax on all their income, whether it is gained from a source in Egypt or from abroad, because of their personal connection to Egypt, that is, on the basis of residence.<sup>1519</sup> Foreign companies are taxed by Egypt on the basis of their territorial connection, that is, on the basis of source. Non-resident companies are subject to tax for their income earned through a *Permanent Establishment* in Egypt: the underlying idea of taxing the income of the permanent establishment in Egypt is the economic connection, which establishes the link between the tax jurisdiction and the income.<sup>1520</sup>

#### 6.4.3 Taxation of residents – inbound payments

Domestic Egyptian taxpayers are taxed on their worldwide income, but a foreign tax credit is given for foreign income taxes on foreign source income up to the Egyptian tax rate.<sup>1521</sup> This implies that Egypt's policy is to give the source country the primary tax jurisdiction on all types of income, either passive income or active income. In this section, the central focus will be on the elimination of international double taxation between Egypt and EU-Member States in the context of the CCCTB system. But before proceeding, it is important to determine Egypt's definition for companies' residency as provided in the current tax treaties between the EU-Member States and Egypt, and to examine to what extent it is compatible with the companies' residency rules under the CCCTB Directive.

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<sup>1518</sup> Art. 47(1) of the Income Tax Law No. 91 of 2005.

<sup>1519</sup> *Ibid.*

<sup>1520</sup> Art. 47(2) of the Income Tax Law No. 91 of 2005.

<sup>1521</sup> Art. 54 of the Income Tax Law No. 91 of 2005.

#### 6.4.3.1 Residence definition

The CCCTB system applies to companies resident in an EU-Member State, but company resident in Egypt can opt for the CCCTB system only in respect to its permanent establishments that are maintained in a CCCTB-Member State.<sup>1522</sup> Under the CCCTB Directive, a company is resident in a Member State where it is incorporated, has its registered office or has a place of effective management therein, unless the relevant tax treaty concluded between the Member State and third country states otherwise.<sup>1523</sup> The CCCTB Directive appears to make reference to the current tax treaties with third countries in determining whether the company is resident in a third country or not. In case of conflict between the tax treaty and the CCCTB in this respect, the tax treaty overrides, i.e. the company shall be considered as a resident in the third country pursuant to the relevant tax treaty.

The vast majority of the tax treaties concluded between Egypt and EU-Member States follow the wording of Art. 4 of the OECD Model.<sup>1524</sup> Art. 4 (1)<sup>1525</sup> defines a resident of a contracting state as follows:

‘For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature,....’

The residency concept may be well understood in domestic laws; however, the OECD definition of residence is unclear and debatable, as it refers to companies which are ‘liable to tax’ under the domestic law of a contracting state. Thus the OECD appears to make reference to the domestic law of the contracting state in defining residence.<sup>1526</sup>

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<sup>1522</sup> Art. 6(1, 2) of the CCCTB Directive.

<sup>1523</sup> Art. 6(3) of the CCCTB Directive.

<sup>1524</sup> See for example ,Art.4 of the tax treaties concluded by Egypt with France, the UK, Italy Poland, Finland, Austria, Spain, Denmark, Romania, Sweden, Greece, Belgium, Netherlands and Bulgaria.

<sup>1525</sup> As per Art.1 of the OECD Model, a tax treaty applies to persons who are “residents” of one or both of the contracting states; the word resident is used rather than “citizen”, “national”, or taxpayer. This implies that defining ‘resident’ for tax purpose is crucial for implementing the most of tax treaty provisions, thus the OECD provides for this definition.

<sup>1526</sup> Howard R Hull, ‘United Arab Emirates: Tax Treaty Relief on International Investment’, Bulletin for International Taxation, February 2009, p.51.

According to the OECD commentary, double tax treaties do not commonly have any involvement with domestic laws of the contracting states which stipulate the conditions under which a company is to be considered as resident and accordingly, is fully liable to tax in that state.<sup>1527</sup> The double tax treaties do not establish criteria which the provisions of the domestic laws on residence have to satisfy in order that claims for full tax liability can be accepted between the contracting states. In this respect, the states take their stance entirely on the domestic laws.<sup>1528</sup> The commentary understates the importance of the words of the OECD provision defining ‘residence’ and suggests that they refer only to domestic law.<sup>1529</sup> Indeed, it is explicitly provided that ‘the definition of resident of a contracting state refers to the concept of residence adopted in the internal law’.<sup>1530</sup>

Moreover, interpreting the OECD definition of resident according to Art.31 of the Vienna Convention, which requires that the treaty provisions should be interpreted in accordance with the ordinary meaning given to the terms of the treaty and in the light of the treaty’s object and purpose, would also reveal that tax treaties refer to the domestic laws of the contracting states in defining tax residence.

The term ‘person’ is clearly defined in Art. 3 (1) (a) of the OECD Model as including ‘an individual, a *company* and any other body of persons’. The term ‘under the laws’ of the contracting state (Art. 4 (1)) would not raise any debate in the case of Egypt and the CCCTB-Member States as there is a comprehensive tax system in force on both sides.<sup>1531</sup> The OECD Model definition includes the notion of being “liable to tax” in order to qualify as a resident for tax purposes, but tax treaties do not define ‘liable to tax’, leaving the meaning of this phrase to the interpretation of the domestic law of the contracting states. It has been concluded that a person is to be considered liable to tax even if the contracting state does not actually impose tax on that person<sup>1532</sup>, i.e. the

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<sup>1527</sup> Commentary to Art.4 of the OECD Model, 2010, para. 8.

<sup>1528</sup> *Ibid*, para. 4.

<sup>1529</sup> Avery Jones, John F. , ‘The origin of concepts and expression used in the OECD Model and their adoption by states’, Bulletin for International Taxation. Vol. 6, 2006, pp.220, 230.

<sup>1530</sup> Commentary to Art.4 OECD 2010, para. 8.

<sup>1531</sup> For the debate on the existence of the tax systems in a certain countries for fulfilling the criterion of ‘under the laws of the contracting state’ see Howard R Hull, ‘United Arab Emirates: Tax Treaty Relief on International Investment’, Bulletin for International Taxation, February 2009, p.52.

<sup>1532</sup> Howard R Hull, ‘United Arab Emirates: Tax Treaty relief on International Investment’, Bulletin for International Taxation, February 2009, p.52

country with the closest connection always has the right to tax, even if it may not exercise its taxing right. Accordingly, the key element when defining whether a company is a resident in Egypt or in a Member State is whether they have the authority to subject that person to unlimited taxation by reason of his domicile, residence, place of management or any other criterion of a similar nature, regardless of whether they use their right to tax or not. Art.4 (1) of the OECD Model establishes a person's residence for treaty purposes by referring to those criteria of domestic law which usually attract taxation according to the rules applicable to persons particularly connected with the state in question. Therefore, under the OECD Model, the phrase 'liable to tax' must be read along with the subsequent words of 'by reason of domicile, residence, and place of management or any other criteria of a similar nature' and tax liability must be established on these criteria.<sup>1533</sup> It can therefore be concluded that the tax treaties concluded between Egypt and EU-Member States establish the definition of company residence on the basis of the domestic law of the contracting states. Therefore, it is critical to set out Egypt's residency rules for companies.

#### **6.4.3.2 Definition of residence in Egypt**

Under the Egyptian tax law, a finding of residency is the primary way that company income is tied to Egypt's tax system. There are three criteria for determining a company residency: for tax purposes, a company is considered to be resident in Egypt if it is incorporated according to Egyptian law, has its place of effective management therein, or 50% of its capital is owned by the state or by a state-owned legal entity.<sup>1534</sup>

As regards the first criterion, the establishment of a company under Egyptian law, for tax purposes a corporation is considered to be resident in Egypt if it is formed or its formation procedures are carried out within the Egyptian territory. Despite the fact that this criterion seems to be simple, certain and easy to determine,<sup>1535</sup> it is nonetheless highly vulnerable to manipulation and subject to the control of the taxpayers, due to its

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<sup>1533</sup> Vogel, Klaus, *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International, 3<sup>rd</sup> edition, 1997), pp. 229-230.

<sup>1534</sup> Art. 47 of the Income Tax Law No. 91 of 2005.

<sup>1535</sup> Arnold, Brian J. and Michael J. McIntyre, *International Tax Primer* (Kluwer Law International, 1995), p.22.

reliance on form.<sup>1536</sup> The taxpayers can elect a state to establish their company where the tax advantages are greater than the country with which the company has a substantial connection, i.e. this criterion can be manipulated and made subject to tax planning.<sup>1537</sup> The rules on transfer pricing, CFC and thin capitalization rules can, however, reduce the vulnerability of the ‘corporation test’ to manipulation.

The drawbacks of the ‘place of incorporation’ test have led the Egyptian legislator to adopt the ‘effective place of management’ test instead. Accordingly, if the company is not established in Egypt, but its effective place of management is located in Egypt, the company is considered to be resident in Egypt. The underlying idea of this test is that the company’s management is usually located in the country where the business activities of the company are carried on, but in the case where the corporation’s business activities are performed in a state and the main place of management of the company is located in another country, the company can be deemed to be resident in the state where the central place of management is situated.<sup>1538</sup> Moreover, Egypt may not be the central place of the company management, but is the effective place of management i.e. the place from where the corporation is actually controlled. The place of effective management can be indicated by some factors such as: the important decisions of the company are processed in Egypt, the general assemblies are held in Egypt, or Egypt is the place of the senior management.<sup>1539</sup>

Furthermore, it has been decided that for those corporations which have their main or central place of management outside Egypt, and whose activities are conducted in Egypt, the main place of management – i.e. residency of the company according to domestic law – is the place where the domestic management exists. Furthermore, if a company is resident outside Egypt and has its activities in Egypt, it is considered to be resident in Egypt in relation to all activities conducted in Egypt.<sup>1540</sup>

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<sup>1536</sup> Reuven S. Avi-Yonah, *International Tax as International Law, An analysis of the International Tax Regime*, (Cambridge, 2007), p.10; Kohl, Uta, ‘The Horror-Scope for Taxation Office: the Internet and its impact of ‘Residence’ University of New South Wales Law Journal, Vol.21, No. 2, 2000), pp.313,316.

<sup>1537</sup> Ramadan sydeik, *Tax Treatment of Mining Companies* (Cairo University, Law School 1993), pp.89-91

<sup>1538</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.46.

<sup>1539</sup> *Ibid.*

<sup>1540</sup> Egyptian Supreme Court, decision No 591/39, 4/2/1980, S31 a 1, p.388.

This test has a number of weaknesses.<sup>1541</sup> For example its meaning is uncertain and needs clarification, as the determination of the effective place of management is usually left to the tax administration, which can create arbitrary decisions.<sup>1542</sup> Consequently, the executive regulations of the income tax law have interpreted the ‘place of effective management’ term. Thus Egypt is deemed to be the place of effective management of a company if two of following four conditions are met: first, where the daily administrative decisions are processed in Egypt; second, when Egypt is the location where the meetings of the company managers or administrative board members are held; third, if at least 50% of the managers or the administrative board members are resident in Egypt; finally, where the participants or shareholders who own more than 50% of the company capital are resident in Egypt.<sup>1543</sup>

It can be noticed that the legislator has confused the place of management and the residency of the shareholders and partners. In other words, the place from which the company is managed is more important than where the shareholders and participants are resident. Therefore, the residency of the partners or managers of the company is not reliable touchstone for the place of effective management. For instance, it is not logical that Egypt is the effective place of management when only the two conditions related to the residency of partners and shareholders are satisfied, while in fact the company is managed from abroad.<sup>1544</sup> However, in addition to these four cases provided above, a general rule has been added to the Executive Regulations, conferring the determination of the effective place of management to the tax administration. It states that the place of effective management will be disregarded as a basis for the residency of the company in Egypt under the above cases, if it becomes evident to the Tax Administration that the company established the place of management only for the purpose of tax planning or tax avoidance.<sup>1545</sup>

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<sup>1541</sup> For more see Michael Dikis, ‘Australia’s Residency Rules of Companies and Partnerships’, IBFD, Vol. 8/9 2003, pp.405-411 at 407.

<sup>1542</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.46.

<sup>1543</sup> Art (3) of Executive Regulation of the Income Tax Law No. 91 of 2005, Decree No, (991) of 2005.

<sup>1544</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.47.

<sup>1545</sup> The Decree of Finance minister No, 193/2006 on the amendment of the Executive Regulation of Income Tax Law No. 91 of 2005.

The *capital ownership criterion* has been newly introduced in income tax law, and under it a corporation is deemed to be resident in Egypt if the majority of its capital is owned by the state as a legal entity, or by a state-owned legal person. The tax law considers that the ownership of 50% of a corporation by the state or the domination of the country on the company is decisive for the residence of an Egyptian company, irrespective of the place of its incorporation or the location of its place of effective management, and whether the company is conducting its activities in Egypt or not.<sup>1546</sup> It can be understood that the Egyptian legislator wanted to make such corporations subject to the Egyptian tax sovereignty as the majority of their capital is owned by the state.<sup>1547</sup>

Nevertheless, it should be noticed that this criterion is not applicable to companies owned by the private sector. Therefore, according to this test, state-owned companies are put in a disadvantageous position compared to companies owned by the private sector, in particular in relation to the avoidance of double taxation.<sup>1548</sup>

#### **6.4.3.3 Dual residency tax treaties**

As mentioned, under Egyptian tax law, a company which is incorporated in Egypt, or where Egypt is its place of effective management, or which is owned by the state or by state-owned legal entities is considered to be resident in Egypt and is taxed on its worldwide income. Like Egypt, the CCCTB Directive adopts the criteria of the place of incorporation and the effective place of management, but the difference is that the capital ownership criterion is adopted in Egypt and the ‘place of registered office’ test is espoused in the CCCTB-Member States. As the CCCTB system and Egypt tax system choose the same criteria for defining company residency, a company can have more than one residency (i.e. dual residency) and double taxation may therefore occur. In this case, a tie-breaker provision for dual residency will be required.<sup>1549</sup> Neither the domestic tax law in Egypt nor the CCCTB Directive contains a provision on dual residency.<sup>1550</sup> The recourse to tax treaties between Egypt and CCCTB-Member States

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<sup>1546</sup> Art. 47 of the Income Tax Law No. 91 of 2005.

<sup>1547</sup> Ramadan Sydeik, *Income Tax Law* (Dar el Nahdah El Arabia, Cairo, 2010), p.75.

<sup>1548</sup> *Ibid.*

<sup>1549</sup> For more discussion on dual company residence see Matthias Hofstätter, Patrick Plansky, *Dual Residence in Tax Treaty Law and EC Law* (Linde 2009), p.50 et seq.

<sup>1550</sup> The CCCTB Directive provided the place of effective management as a tie-breaker rule to be used for tax residence allocation, for companies resident in more than one Member State in the EU, but this rule is not applicable to situations beyond the EU water’s edge, see Art. 6(4) of the CCCTB Directive.

would thus be of great assistance. In order to avoid double taxation, Art. 4 (3) of most of Egypt's modern tax treaties incorporate a tie-breaker rule for companies. It is equivalent to Article 4 (3) of the OECD upon which Egypt-EU Member States tax treaties are based. It states that where a company is a resident of both contracting states, it will be regarded as a resident only of the state in which its place of effective management is located.<sup>1551</sup> Normally, the place of effective management is the place where the action to be taken by the company as a whole is decided, i.e. the place where the decisions are made by the board of directors. Nevertheless, the place of effective management is ultimately determined by the circumstances and facts.<sup>1552</sup> What constitutes 'the place of effective management' lacks guidance in the OECD commentary, but as noted by the OECD it can be determined by the 'central management and control' test or 'place of management' test.<sup>1553</sup>

Therefore, according to Art.4 (3) of the Egyptian tax treaties, the place of effective management will be used as a tie-breaker rule for tax residence allocation, for companies resident in more than one state, i.e. in Egypt and in a Member State of the EU. It will also serve to indicate when an Egyptian company can opt for the CCCTB scheme. In other words, following the residency rules in the CCCTB Directive and Egyptian tax law, a company would be resident in both jurisdictions; in this case the decisive test for Egyptian companies to opt for the CCCTB system( in respect of their permanent establishment located in the CCCTB jurisdiction) is that their 'place of effective management' is in Egypt.

#### **6.4.3.4 Taxing inbound income and relief for foreign taxes**

Inbound income tax rules will now be considered. These apply to residents in Egypt who derive income from abroad, especially from potential CCCTB-Member States. Generally speaking, international double taxation typically originates from the overlaps in the taxing rights, i.e. certain countries may impose taxes on the basis of residence nexus whilst the other countries levy taxes on the basis of the source connection; this is

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<sup>1551</sup> For a historical background on this test see Luca Cerioni, 'The "Place of Effective Management" as a Connecting Factor For Companies' Tax Residence Within the EU vs. the Freedom of Establishment: the Need for a Rethinking?', German Law Journal, Vol,13, No. 9,2012,pp. 1095-1130.

<sup>1552</sup> Commentary on Art.4 of the OECD Model 2010, paras. 22and 24.

<sup>1553</sup> OECD, 'The Impact of the Communication revolution on the application of place of effective management 'as a Tie-Breaker Rule: Discussion Draft (Paris: OECD, 2001).



known as ‘residence-source overlap’. International double taxation can also be triggered from the overlap of tax-based residence-residence and source-source.<sup>1554</sup> It can be noticed that as both Egypt and the CCCTB Directive tax the worldwide income of residents and source income of non-residents, the overlap between the tax jurisdictions of both sides is obvious. In this respect, Egypt taxes residents on their worldwide income i.e. income derived from a CCCTB-Member State by a resident in Egypt is subject to tax under the Egyptian tax law. On the other hand, the same income is taxable in the CCCTB jurisdiction under the source taxation principle, and this means that international double taxation is inevitable. International double taxation is avoided both by unilateral measures and by bilateral double taxation treaties.<sup>1555</sup>

#### **6.4.3.4.1 Foreign tax credit in domestic tax law**

The credit method is invoked by Egyptian income tax law: it states that the foreign tax paid on income realised overseas by a resident company in Egypt is to be credited against the corporate tax payable in Egypt according to the current income tax law. However, losses incurred abroad are not deductible from tax paid in Egypt.<sup>1556</sup> There are two conditions provided for the application of the credit method in Egypt. The first one is that the credit granted may not exceed the total tax payable in Egypt that may have been due with regard to the income gained from works carried out abroad; meaning that the ordinary credit method applies. The second condition stipulates that the related supporting documents of the foreign tax paid abroad have to be presented.<sup>1557</sup>

#### **6.4.3.4.2 Treaty relief from double taxation**

##### **6.4.3.4.2.1 Credit method in Egypt –EU-Member States Treaties**

Under the credit method, the state of residence provides a credit for the taxes paid in the source state. The credit is available as a deduction from the tax payable in the state of residence. Egyptian tax treaties that provide for a credit method usually follow Art. 23 B of the OECD Model,<sup>1558</sup> which follows the ordinary credit method.<sup>1559</sup>

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<sup>1554</sup> Mogens Rasmussen, *International Double Taxation* (Kluwer Law International 2011), p.1 et seq

<sup>1555</sup> Commentary on Arts. 23A and 23B of the OECD, 2010, para. 32.

<sup>1556</sup> Art. 54 of the Income Tax Law No. 91 of 2005.

<sup>1557</sup> *Ibid.*

<sup>1558</sup> This Article reads as follows:

‘Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-

The tax treaties concluded between Egypt and EU-Member States, which adopt the credit approach, such as the Egypt-Spain tax treaty,<sup>1560</sup> confer on the state of residence the right to apply a progressive scale of tax rate, i.e. the state of residence retains the right to take the amount of credited income or capital into consideration when determining the tax to be imposed on the rest of the income. In this aspect, the tax treaties signed by Egypt follow Art. 23 B (2) of the OECD Model.<sup>1561</sup>

However as a departure from the OECD provisions, most of the tax treaties concluded by Egypt provide for a general tax-sparing mechanism as follows:

‘For the purposes of deduction from the tax on income in a Contracting State, the tax paid in the other Contracting State shall be deemed to include the tax which is otherwise payable in that other Contracting State but has been reduced or waived by that Contracting State under its legal provisions for tax incentives’.<sup>1562</sup>

Preventing international double taxation via the ordinary credit method, which is associated with a general tax-sparing mechanism, is found in the following treaties: Egypt-*Poland* treaty (1996) Art. 24; Egypt-*Cyprus* tax treaty (1993) Art. 23; Egypt-*Denmark* treaty (1989) Art. 23; Egypt-*Greece* treaty Art. 24; *Malta* (1999) Art. 23, and *Slovakia* (2004), Art. 23. Nevertheless, some tax treaties relieve double taxation by the ordinary credit method as mentioned above, but provide for a *limited* tax-sparing clause. For instance, according to the tax convention between Egypt and *Italy* (1979) Art. 23, double taxation is avoided in both countries according to the ordinary tax credit method, but as an exception in Italy the credit is not allowed if the item of income is subject in Italy to a final withholding tax by request of the recipient of the said income in

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mentioned State shall allow as a deduction from the tax on the income or on the capital of that resident, an amount equal to the income tax or to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State’.

<sup>1559</sup> Commentary on Art. 23 B OECD 2010, para.57.

<sup>1560</sup> See Art. 23 of tax treaty between Egypt and Spain, 2005.

<sup>1561</sup> This paragraph reads as follows:

‘Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital’.

<sup>1562</sup> See for example Egypt-Greece Tax Treaty Art.24 (3).

accordance with Italian law.<sup>1563</sup> A tax-sparing mechanism is applicable on both sides, Egypt and Italy, and it is only granted in respect of the tax on business profits, dividends and interest, which is exempted or reduced for a limited period in accordance with the laws of those contracting states, either Egypt or Italy. The effect of the tax-sparing clause is that when granting a credit for foreign tax, the foreign tax which has been exempted or reduced will be deemed to have been paid at a maximum tax rate of 25%.<sup>1564</sup>

**United Kingdom:** The tax treaty concluded between Egypt and the United Kingdom (1987) Art.22, eliminates double taxation by applying the ordinary credit method for *both countries*. Exceptionally, the Egypt-UK tax treaty provides for the elimination of international economic double taxation in respect to dividends paid by a company that is a resident of Egypt to a company that is a resident of the United Kingdom and *vice versa*. If the company receiving the dividends income controls directly or indirectly at least 10% of the voting rights in the company paying the dividends, the credit granted by the residence state has to take into account the tax payable by the company in the source state in respect of the profits out of which such dividends are paid.<sup>1565</sup>

Under this tax treaty, a tax-sparing clause is applicable in relation to the ‘Egyptian tax payable’, which includes any amount that would have been paid as Egyptian tax for any year but is not paid by virtue of tax incentives granted for that year. In particular, these tax incentives include any exemption or tax reduction which is granted either under Articles 16 and 18 of Law No. 43 of 1974 in so far as these Articles are in force, and have not been modified since the date of signature of this convention,<sup>1566</sup> or any other laws which may subsequently be made granting tax incentives on condition that these laws are substantially similar to the above law.<sup>1567</sup>

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<sup>1563</sup> Egypt-Italy Tax Treaty, Art.23 (3).

<sup>1564</sup> Egypt-Italy Tax Treaty, Art.23 (4).

<sup>1565</sup> Egypt-United Kingdom Tax Treaty Art.22 (1 and 2).

<sup>1566</sup> It is agreed that the amendment to Art. 16 of Law No.43 of 1974 by Law No.32 of 1977 does not affect the entitlement to credit for tax 'spared' under the original law as so modified.

<sup>1567</sup> Egypt-United Kingdom Tax Treaty Art.22 (1); The following Articles are agreed to be substantially similar to Article 16 of Law No.43 of 1974 such that the provisions of paragraph 3 of Article 22 apply by virtue of sub-paragraph 3(b); the Law No. 59 of 1979, Article 11 of Law No. 230 of 1989 and Article 16 of Law No. 8 of 1997 and credit may also be granted for tax spared pursuant to these laws, see <<http://www.hmrc.gov.uk/manuals/dtmanual/dt6450+.htm>> accessed 15 December 2012.

#### 6.4.3.4.2.2 Exemption method and the combination of both approaches

Under the tax exemption method, the income that is taxed in the source state is exempted in the residence state. The exemption approach adopted in the Egyptian tax treaties generally follows Art. 23 A of the OECD Model, and although these tax treaties do not follow the exact wording of this provision, the substance of ‘the exemption method with progression’ is usually adopted. For instance, the tax treaty between Egypt and *Romania* states that:

‘where a resident person in a contracting state derives income from [an] other contracting state and this income pursuant to the provisions of this treaty may be taxed in the other contracting state, the first-mentioned contracting state shall exempt such income from tax but may, in calculating tax on the remaining income of that person, apply the rate of the tax which would have been applicable if the exempted income had not been so exempted’.<sup>1568</sup>

Some of the tax treaties concluded between Egypt and EU-Member States implement the exemption method in combination with the ordinary credit method.

***Romania:*** In the tax treaty signed between Egypt and Romania in 1979 (Art. 24), the exemption method with progression is applicable for both countries; however, in respect to dividends, interest, royalties, capital gains, and dependent personal services, the ordinary credit method applies. Moreover, the agreement provides for credit to be given for tax ‘spared’ in Egypt under those provisions of Egyptian law, in particular, Art. 16 of the Egyptian Law No. 43 of 1974 as amended by Law No. 32 of 1977. Under this tax-sparing clause, the Romanian company is considered to have paid the Egyptian tax which would have been paid by this company, but it is exempted by virtue of the above-mentioned law, and so this tax will be deducted from the tax due in Romania.<sup>1569</sup>

***Finland:*** The tax treaty concluded between Egypt and Finland in 1965 (Art. 23) contains the exemption with progression mechanism as the main method for the elimination of double taxation, and the ordinary credit method is applicable only in

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<sup>1568</sup> Egypt-Romania Tax Treaty Art. 24(1).

<sup>1569</sup> Egypt-Romania Tax Treaty Art. 24(3).

respect to interest, dividends and royalties. However, no tax-sparing clause was provided in this tax convention.

**Bulgaria:** According to the tax convention between Egypt and Bulgaria in 2003 (Art. 23, international double taxation is avoided *in Egypt by crediting the foreign tax paid* in Bulgaria up to the Egyptian tax rate. In addition, Egypt has the right to take the amount of exempted income into consideration when determining the tax to be imposed on the rest of the income. On the other hand, double taxation is eliminated in Bulgaria by adopting the exemption method with progression regarding the income which is taxed in Egypt. However, the tax imposed on dividends, interest and royalties which are sourced in Egypt are credited from the tax payable in Bulgaria. Moreover, a general tax-sparing clause is contained in the tax convention, and it is available for both countries, Egypt and Bulgaria.

**Austria:** The tax convention concluded between Egypt and Austria in 1962 (Art. 21) contained a combination of exemption and credit methods. Income derived in Egypt is *fully* exempted in Austria and vice versa, and both countries retain the right to take the exempted income into account when determining its tax rate. Nonetheless, tax collected on dividends, interest and royalties in a contracting state is deductible from the tax payable in the other contracting state, and is computed on the basis of an average rate of tax. No tax-sparing mechanism is provided in the Egypt-Austria tax treaty.

**Sweden:** Under the Egypt-Sweden tax treaty in 1994, Art. 23 (2) stipulates that double taxation is avoided in Egypt by fully exempting from Egyptian tax the income which is taxed in Sweden. In contrast, interest, dividends, royalties, immovable property income, commercial and industrial profits and capital income are taxable in Egypt, but a credit is given up to the Egyptian tax rate for the tax paid in Sweden. On the other hand, double taxation is avoided in Sweden by the application of the full exemption approach. In addition, a tax-sparing clause is provided in this tax treaty for ‘the Egyptian payable tax’ that should have been paid but was exempted or reduced according to Law No. 230 of 1989 related to investment incentives. Nevertheless, the tax-sparing clause is temporary; it is applicable only for ten years from the date of the application of this treaty. After this period of time, the tax-sparing is subject to negotiation by the competent authorities as to whether this clause is to be extended.

**France:** As regards the elimination of double taxation between Egypt and France, according to the tax treaty of 1980 each country exempts the income and capital which is taxable in the other country according to the provisions of this treaty. However, for dividends, interest and royalties which are taxed in one contracting state, either Egypt or France, a double tax relief by credit is given in the other contracting state up to its corporate tax rate. Nonetheless, in France the tax credit allowed for dividends, interest, and royalties will be the highest of the following amounts: the amount of the Egyptian tax actually levied, 25% of the gross amount of dividends income, or 20% of the gross amount of interest and royalties income, provided that the provisions of Articles 16 and 18 of the Egyptian Law No. 43 of 1974 as amended by law No. 23 of 1977 apply to such income.

**Belgium:** The tax convention concluded between Egypt and Belgium in 1991 implements a combination of exemption and credit methods for eliminating international double taxation. Under Art. 23 of this tax treaty, income taxed in Belgium is fully exempted in Egypt; however, the ordinary credit method applies to dividends, interest and royalties. Notwithstanding, according to this convention Egypt has the right to take into consideration the amount of exempted income in its jurisdiction when determining the tax to be levied on the rest of the income. On the other hand, double taxation is avoided in Belgium by applying the exemption method with progression, but foreign taxes paid on interest, dividends and royalties are credited up to the tax rate stipulated in Belgian law. A limited amount of tax-sparing is granted to Egypt when a resident in Belgium receives dividends or interest income which would have been taxed in Egypt, according to the provisions of this tax convention, but it is exempted pursuant to the Egyptian Law No. 43 of 1974 as amended by Law No. 23 of 1977. The agreement provides for credit to be given for tax 'spared' in Egypt under the above-mentioned law, but the amount of the credit is limited to 20% of the gross income.

**Netherlands:** Double taxation elimination in the tax treaty concluded between Egypt and Netherlands (1999) varies from the manner that is followed in the previous countries. In principle, the treaty does not lay down a main method for elimination of double taxation. The Netherlands applies the exemption method with progression in respect of some categories of income and the ordinary credit method to other types of

income (see paragraph 2 and 3, Art. 22). In the case of Egypt, where income, in accordance with the provisions of this agreement, is subject to tax in both contracting states, relief for double taxation is given as follows: Netherlands tax payable in respect of income derived from the Netherlands shall be allowed as a credit against Egyptian tax payable in respect of that income. Where such income is dividends and is paid by a company resident in the Netherlands to a company resident in Egypt which owns directly or indirectly not less than 10% of the share capital of the first-mentioned company, the credit shall take into account the Netherlands tax payable by that company on the portion of its profits out of which the dividend is paid. The credit shall not however exceed that part of the Egyptian tax, as computed before the credit is given, which is appropriate to such items of income.

**Hungary:** The tax treaty between Egypt and Hungary (1991) Art. 23 does not differ from the approach of combining the two methods for the elimination of double taxation. Double taxation is avoided in Egypt by applying the *ordinary credit method*, whereas in Hungary the exemption method with progression is used in order to prevent the existence of double taxation, except for the income of interest, royalties and dividends, where the ordinary credit method is applicable. Both countries retain the right to take the exempted income into consideration when calculating the tax to be imposed on the rest of the income. A general tax-sparing clause is available for both of the contracting states.

Although Egypt is not an OECD member, the vast majority of tax treaties concluded between Egypt and EU-Member States follow the wording of the OECD provisions in respect to the elimination of double taxation. In most of the Egyptian tax treaties, income derived by Egyptian companies from EU-Member States is granted a tax credit for the foreign tax paid therein. Other Egyptian tax treaties apply exemption method in respect of income sourced in the EU-Member States, but passive income, i.e. dividends, interest and royalties, which may be taxed therein under the provisions of the relevant tax treaty, is subject to the ordinary credit method. Against this background, the impact of the CCCTB rules on Egyptian tax treaties will be examined. In other words, the compatibility of Egyptian outbound investment tax rules – either under the domestic or tax treaty law – with the CCCTB rules will be examined. In this respect, it is critical to distinguish between business and passive income.

#### 6.4.3.5 Inbound business income

##### *Income from a foreign permanent establishment to a domestic head office*

As mentioned, methods invoked to eliminate double taxation in Egyptian tax treaties cover income derived by an Egyptian company from an EU source, which is taxed therein according to the provisions of the relevant tax treaties. The most important income item that is covered by these tax treaties is *business income*. In the majority of Egypt-EU-Member States' tax treaties,<sup>1570</sup> the article equivalent to Art. 7(1) of the OECD Model stipulates that where an Egyptian company derives income from an EU-Member State through a permanent establishment located therein, the income is exclusively taxed in the respective EU-Member State. Under the CCCTB Directive, the income of a permanent establishment located in the CCCTB jurisdiction and owned by an Egyptian head office will be taxable pursuant to the CCCTB rules.<sup>1571</sup>

However, this income is also taxable in Egypt on the basis of the worldwide taxation concept, i.e. business income derived by a resident from abroad, and will result in double taxation. As established above, most of the Egyptian tax treaties avoid double taxation by invoking the credit method, but a few of them provide for the exemption method to relieve double taxation. In this respect, the CCCTB rules are consistent with Egypt's international tax rules. However, inconsistency arises with respect to the method for income attribution to the permanent establishment in question, as where the permanent establishment qualifies as a group member in the CCCTB jurisdiction, its income is consolidated and apportioned according to the CCCTB-Formulary apportionment. In contrast, under Egyptian tax treaties, a provision based on Art. 7 (2) of the OECD Model allocates business income to the permanent establishment on the basis of the arm's length principle.<sup>1572</sup> Some complexities arise where the amount of income attributed to the permanent establishment pursuant to the CCCTB-formulary apportionment basis is higher than the amount allocated pursuant to the arm's length

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<sup>1570</sup> Egypt-EU-Member States Tax Treaties that follow Art. 7 of the OECD Model are Egypt -Cyprus, the Netherlands, Austria, Poland, Finland, Romania, the UK, Italy, Denmark, Sweden, Belgium, Spain, Bulgaria, Greece, and Egypt- France tax treaty.

<sup>1571</sup> A permanent establishment owned by an Egyptian head office and situated in a CCCTB Member State is subject to tax under the CCCTB system only when the head office opts for such scheme, see Art. 6(7) of the CCCTB Directive

<sup>1572</sup> When addressing the income attribution issue, it has to be pointed out that for Egyptian tax purposes branches or permanent establishments do not constitute an independent taxable entity but are instead part of the overall company. The independency of the permanent establishment does arise only from a legal fiction based on Art. 7 of the OECD Model, which is followed by almost all Egyptian tax treaties.



principle. Firstly, where Egyptian tax treaties provide for a credit for tax paid abroad, which is the case in the vast majority of its tax treaties with EU-Member States as established above, it has to give a higher amount of credit, and consequently its taxable share would shrink.

In order to eliminate the objection by Egypt, certain short-term solutions have been suggested. As established in the previous chapter, it has been proposed that when double taxation is relieved by means of the credit method in the third country (Egypt), the amount of the tax credit could be limited to the level of an “arm’s length” attribution of profits to the EU-located permanent establishment even if it is less than the amount of profit attributed to the permanent establishment under the CCCTB-formulary apportionment. However, it has been shown that this solution is not workable, and it is also evident that the recourse to tax treaty provisions similar to Art. 7 (4) of the OECD do not offer an adequate solution.

One possible solution is for Egypt to switch from the credit method to the exemption method in respect of income received by Egyptian head office from EU-permanent establishment. This would be the case as regards the tax treaties concluded between Egypt and Spain, Poland, Greece, Denmark, Malta, Slovakia, Italy, the UK, Hungary, Bulgaria and Cyprus.

Furthermore, if, for the purpose of eliminating double taxation, Egyptian tax treaties exempt the income of an EU-permanent establishment, Egypt would not object to attributing the income to the permanent establishment on the CCCTB-formulary apportionment basis, and there would be no need to amend the relevant tax treaties. In other words, since the income of an EU-permanent establishment is not taxable in Egypt (exempted) in some of the Egyptian tax treaties, the overlap between the permanent establishment’s tax liability computed under formulary apportionment and its tax liability under the arm’s length basis does not raise any objection by Egypt. This would apply to the tax treaties signed between Egypt and Romania, Finland, Austria, Sweden, France, Belgium and the Netherlands.

#### 6.4.3.6 Inbound passive income

As regards passive income, i.e. dividends, interest and royalties, derived by an Egyptian company from a potential CCCTB-Member State, the CCCTB Directive does not lay down common rules on withholding taxes to be imposed on such income; instead it refers to the existing domestic arrangements of a Member State's domestic law and tax treaties. This implies that a CCCTB-Member State will be free to levy withholding taxes and to set its level on the passive income paid to a company resident in Egypt, unless otherwise provided by an applicable double tax treaty.

Where a double tax treaty applies between an EU-Member State and Egypt, a wide variety of situations can occur. For *Dividends*, the OECD Model generally authorises the source state to impose 15% withholding taxes. Some tax treaties of the EU-Member States provide for a maximum 20% rate, as in the case of the UK.<sup>1573</sup> Several tax treaties follow the OECD Model and authorise withholding taxes up to 15%, and this appears in the tax treaties concluded with Egypt by Belgium,<sup>1574</sup> Cyprus,<sup>1575</sup> the Netherlands<sup>1576</sup> and Denmark.<sup>1577</sup> Other tax treaties bring the withholding tax rate down to 10% such as those of Austria,<sup>1578</sup> Finland,<sup>1579</sup> Bulgaria and Greece. Few tax treaties bring the rate down to 5%, as do those of France and Sweden.

For *Interest*, whereas the OECD Model authorises the source state to levy 10% withholding taxes, actual double tax treaties concluded between EU-Member States and Egypt vary widely, ranging from 0%, as in Austria<sup>1580</sup> and Finland,<sup>1581</sup> to 15%, as in the UK.<sup>1582</sup>

For *Royalties*, the 0% rate of the OECD appears in some tax treaties of the EU-Member States with Egypt, namely in Austria,<sup>1583</sup> but other countries impose withholding taxes

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<sup>1573</sup> Art. 10 (1), (2) of the Egypt-UK tax treaty, 1987.

<sup>1574</sup> Art. 10(2) of Egypt-Belgium tax treaty, 1991.

<sup>1575</sup> Art.10 (2) Egypt-Cyprus tax treaty, 1993.

<sup>1576</sup> Art. 10 (2) of the Egypt-Netherlands tax treaty, 1999.

<sup>1577</sup> Art. 10(2) Egypt-Denmark Tax treaty, 1991.

<sup>1578</sup> Art. VIII (2) of Egypt-Austria tax treaty, 1964.

<sup>1579</sup> Art. 10(1) of Egypt-Finland tax treaty 1966.

<sup>1580</sup> Art. X (2) of Egypt-Austria tax treaty, 1964.

<sup>1581</sup> Art. 11(2) of Egypt-Finland tax treaty 1966.

<sup>1582</sup> Art. 11 (2) of the Egypt-UK tax treaty, 1987

<sup>1583</sup> Art. XI (1) of Egypt-Austria tax treaty, 1964.

of up to 15%, as in Italy (Art. 12 (2) of the Egypt-Italy tax treaty), Greece and France, while some countries, such as Finland <sup>1584</sup> bring the rate up to 25%.

Since the withholding taxes are imposed on these types of passive income in the respective EU-Member States at different rates, and since when this income is received by an Egyptian company it is also subject to tax in Egypt pursuant to the worldwide taxation principle, a relief for double taxation is essential. Under almost all tax treaties concluded between Egypt and EU-Member States (as outlined above), Egypt is committed to giving credit up to the Egyptian corporate tax rate for foreign tax paid in the EU-Member State concerned. Therefore, the taxation of passive income received by an Egyptian company does not raise any complexities with the CCCTB system as there are no common rules provided in the CCCTB Directive.

#### **6.4.3.6.1 Controlled Foreign Companies (CFC rules)**

The differentiation between business and passive income involves deferral taxation.<sup>1585</sup> The deferral of current Egyptian taxation on foreign passive income is possible due to the fact that only resident taxpayers are taxed on their worldwide income, and that the taxpayers can choose between classification as a resident or non-resident according to the formal territory or the management of their company. In other words, a company can be considered as non-resident in Egypt because it is not incorporated or managed from Egypt, and a taxpayer could defer current Egyptian tax on foreign-sourced income by shifting it to a subsidiary incorporated overseas. Income-shifting is possible only for foreign source income, as both residents and non-residents are taxed on Egypt-sourced income.

The corporate tax base in Egypt includes income from investment in non-resident companies. This income is recognized under the equity method of revenue recognition and consequently is included in the tax base. Nonetheless, as passive source-income is not taxable in Egypt until it is distributed, the taxpayer can decide when to distribute dividends, interest and royalties that are derived from the foreign subsidiary, thus the taxation is postponed or deferred until the distribution is exercised. If the subsidiary

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<sup>1584</sup> Art. 12(1) of Egypt-Finland tax treaty 1966.

<sup>1585</sup> Reuven S. Avi-Yonah, *International Tax as International Law, an analysis of the International Tax Regime* (Cambridge, 2007), p.24.

were incorporated in a tax haven, the result would be no current taxation of the foreign source income of the subsidiary for the period of deferral. To counter this practice Egypt has recently adopted an anti-deferral regime.

The Egyptian CFC or anti-deferral rules apply to an Egyptian company where three conditions are fulfilled: firstly, if the Egyptian entity owns more than 10% of the CFC; secondly, if more than 70% of the income accruing to the entity falls within passive income, such as dividends, interest, royalties, management fees or rental fees; thirdly, where the non-resident company is not subject to tax in the residence country, is tax exempted or taxable at a statutory corporate tax rate lower than 15%.<sup>1586</sup> It can be submitted that the Egyptian CFC rule combats income-shifting, especially passive income, to low tax countries, which is the same objective as that of the CCCTB's CFC rules.<sup>1587</sup> However, the ownership requirement for applying the Egyptian CFC rule (10% of the CFC) is stricter than the CCCTB's CFC rule (where 50% of the capital of the CFC is owned by the CCCTB taxpayer).<sup>1588</sup>

#### **6.4.4 Taxation of non-residents – outbound payments**

##### *Source taxation*

Under Egyptian tax law, companies that do not qualify as resident according to the criteria provided above are treated as non-resident, i.e. they are taxed only on their income derived from an Egyptian source.

Generally, as the source rules establish the nexus between the income and a tax jurisdiction, taxing the income of a non-resident in a certain jurisdiction implies that this income is linked and derived from a source within such jurisdiction. The source rules, as prescribed in the Egyptian income tax law, tax a non-resident company that does not have a permanent establishment in Egypt, on their income that is sourced in Egypt. It is submitted that income is considered to be derived from an Egyptian source when it is constant, due and confirmed in its existence and amount by the agreement of the parties

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<sup>1586</sup> Art. 70(6), (B) of Executive Regulation of the Income Tax Law no. 91 of 2005, Decree No. (991) of 2005.

<sup>1587</sup> Art. 82(1) (b) of the CCCTB Directive.

<sup>1588</sup> Art. 82(1) (a) of the CCCTB Directive.

concerned, or by a final decision by a court of law. This income is taxed in Egypt even if the taxpayer is not resident in Egypt insofar as it is sourced from Egypt's jurisdiction.<sup>1589</sup> However, income sourced in Egypt does not mean that it has to be received from Egypt, i.e. if the whole or part of the income is received from outside Egypt jurisdiction, the income would be still regarded as Egypt-sourced. For instance, if a doctor conducts a medical operation in Egypt and receives his salary from abroad, his income is considered to be gained from a source in Egypt regardless of the place of receiving the income.<sup>1590</sup>

Egyptian income tax law does not contain a general source rule but regards some types of income as sourced in Egypt.<sup>1591</sup> These income types include: income accrued from services rendered in Egypt, including salaries and the like, even if the work is carried out abroad and the income is paid by an employer resident in Egypt; income from activities carried out in Egypt by a sportsman or an artist; income earned by a non-resident for business carried out by a permanent establishment in Egypt; and income gained from the disposal of the movable property of the permanent establishment. Likewise, the profits realized from the use and the disposal of real estate situated in Egypt and the like, such as planes and ships. Dividends paid by an Egyptian shareholding company as well as the distribution of a partnership resident in Egypt are also treated as Egypt-sourced income. The interest paid by the Egyptian government, local authority units, state-owned legal entities or any resident in Egypt, and interest which is paid by a permanent establishment resident in Egypt even if its owner is not resident in Egypt, as well as rental payments, licensing fees and royalties paid by a permanent establishment or tax-resident in Egypt are all regarded as having their source in Egypt.<sup>1592</sup>

It should be stressed that these types of income are provided as examples of income sourced in Egypt, as the income tax law after listing these examples states a general provision that any income gained from any other activities carried out in Egypt will be

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<sup>1589</sup> Al Saied Abd El Mola, *The Egyptian Tax Legislation* (Dar el Nahdah el Arabia, Cairo, 2005), p.42.

<sup>1590</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.48.

<sup>1591</sup> Art. 3 of the Income Tax Law No. 91 of 2005

<sup>1592</sup> Art. 3 of the Income Tax Law No. 91 of 2005

treated as Egypt-sourced income.<sup>1593</sup> It can be noticed that the business and passive income of non-residents, which are derived from an Egyptian source, are subject to tax according to Egyptian tax law. The taxation of both types will be considered in greater detail below.

#### **6.4.4.1 Taxation of non-residents: business income**

The taxation of the active business operations of a non-resident in Egypt is straightforward. Income earned by a non-resident company from an Egyptian source through a permanent establishment is taxed at the regular rates and on the same basis as income earned by domestic taxpayers, i.e. it is calculated in accordance with the rules for resident companies. Moreover, the crucial term, *permanent establishment*, is defined in the Egyptian tax code.

##### ***Taxation of a domestic permanent establishment***

In accordance with Art. 7 of the OECD Model, the domestic permanent establishments of non-residents in Egypt are subject to tax on income attributable to them.<sup>1594</sup> However, under the CCCTB Directive, income received from an Egyptian permanent establishment by its head office which is resident in a CCCTB Member State is not subject to tax therein; pursuant to Art.23 B of the OECD Model, the CCCTB Directive eliminates double taxation in respect of foreign permanent establishments by means of the exemption method with progression.<sup>1595</sup> In other words, under the CCCTB scheme and international corporate tax rules in Egypt, the taxation of income which is paid by a permanent establishment situated in Egypt to its head office resident in a CCCTB Member State does not raise any incompatibility.

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<sup>1593</sup> Art. 3 of the Income Tax Law No. 91 of 2005

<sup>1594</sup> Art. (47(2)) of the Income Tax Law No. 91 of 2005. It has to be stressed that in the absence of express legislative, judicial and administrative guidance regarding intra-company dealings especially between an Egyptian corporation and foreign permanent establishment or vice versa, it seems that Egypt will rely on the arm's length principle as contained in the Art.7(1) of the OECD Model. Egyptian income tax law does not contain any rules on the attribution of income to a Permanent establishment, hence Egyptian tax payers can fully rely on separate entity approach as contained in Art.7(2) of the OECD Model. Indeed, income or expenses allocation to a permanent establishment rules in almost all Egypt tax treaties are based on Art. 7(2) of the OECD Model. The Egyptian Tax authority (ETA) has issued Transfer Pricing Guidelines calculating arm's length price according to the approach in the OECD ones, but these guidelines are not applicable to the dealings between a permanent establishment and its head office. The ETA intends to issue separate regulations regarding the tax treatment of Permanent Establishments, including the pricing of transactions between head office and its permanent establishments, see Egypt Transfer Pricing Guidelines, p.6.

<sup>1595</sup> Art. 11(c) of the CCCTB Directive.

#### 6.4.4.1.1 Definition of permanent establishment under Egyptian tax law

The definition of ‘permanent establishment’ has been newly introduced into Egyptian tax law<sup>1596</sup> as ‘each fixed place of business through which some or all works of projects of a non-resident in Egypt is carried out’. This definition shows that three conditions are required. Firstly, there must be a *place of business*, which encompasses any premises, facilities or installation used for carrying out the business of the permanent establishment. The place of business does not have to be available or required for carrying on the business of the company, but as long as it has a specific amount of space at its disposal then the place of business exists.<sup>1597</sup> Secondly, the place of business has to be *fixed*, which implies that there must be a connection between the place of business and a specific jurisdiction.<sup>1598</sup> This condition indicates that the permanent establishment can be considered to exist only if the place of business has a certain degree of permanency.<sup>1599</sup> Thirdly, the business must be *carried out wholly or partly* through the fixed place of the business.

The income tax law provides some examples of what constitutes a permanent establishment: it includes a place of management, a branch, a building used as a sales outlet, office, factory, or workshop, a mine, oil field, natural gas well, quarry or any other place for extracting natural resources, including timber or any other product from forests, or a plantation farm, building site, construction project, or assembly, and the preparation or supervisory activities related to any of these businesses.<sup>1600</sup>

Against these examples, it should be pointed out that the ‘place of management’ is used differently from the term ‘office’, which implies that they are not identical and each one can constitute a permanent establishment insofar as the above conditions of the permanent establishment are met. Furthermore, a mining activity, quarrying or any other activities for extracting natural resources are considered to constitute a permanent

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<sup>1596</sup> Art. 4 of the Income Tax Law No. 91 of 2005

<sup>1597</sup> P. Gopinath, ‘Importance of Permanent Establishment and Business Connection to Double Taxation Avoidance Agreements’, *Taxman*, Vol.129, No, 133(2003), p.142.

<sup>1598</sup> Skaar, Arvid A., *Permanent establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1995), p. 99.

<sup>1599</sup> P. Gopinath, ‘Importance of Permanent Establishment and Business Connection to Double Taxation Avoidance Agreements’, *Taxman*, Vol.129, No, 133(2003), p.142.

<sup>1600</sup> Art. 4 of the Income Tax Law No. 91 of 2005.

establishment irrespective of the place; and whether on land or sea, either inside the country's jurisdiction or in an offshore system.<sup>1601</sup>

Additionally, the Egyptian legislator considered that a person who is working for an affiliated enterprise and has the authority to conclude and execute contracts on behalf of the foreign company is deemed to constitute a permanent establishment. However, if the person's authority is restricted to the activity of procurement of goods and commodities for the company, it would not constitute a permanent establishment.<sup>1602</sup>

Moreover, despite the fact that a foreign enterprise can conduct its business through a fixed and permanent place of business, the right to tax this business cannot be given to Egypt due to the fact that the activities which are carried out by this place of business has a *supporting or preparatory* nature. As a result of the difficulty of distinguishing between the supporting or preparatory activities and the productive activities, the income tax law has provided cases<sup>1603</sup> that do not constitute a permanent establishment. These cases include the usage of the facilities which are granted for the foreign enterprise only for the purposes of the storage and display of goods and commodities which are owned by the foreign enterprise; when the main purpose of maintaining a permanent place of business is for an activity that only undertakes work of a preparatory or supporting nature to the project; an activity that only undertakes the purchase of goods or commodities or the gathering of information for the project, or the reprocessing of these goods and commodities by another project.

Furthermore, in the case where a foreign company conducts commercial or industrial activities through a broker or a general agent on commission, or any other independent agent, these agents do not constitute a permanent establishment unless it is evident that the broker or the agent is dedicating most of its time and effort to the interests of the foreign company during a specific tax period.<sup>1604</sup> In relation to the interpretation of the term 'dedicating most of its time and effort to the interests of the foreign company', the executive regulation of the income tax law states that when the broker or the agent is

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<sup>1601</sup> Ramadan Sydeik, *Interpretation and the Application of Double Tax Treaties* (Dar el Nahdah El Arabia, Cairo, 2007), p.105.

<sup>1602</sup> Art. 4 of the Income Tax Law No. 91 of 2005.

<sup>1603</sup> *Ibid.*

<sup>1604</sup> For more on this case see John F., David A. Ward, 'Agents as Permanent Establishments under the OECD Model Convention', *European Taxation*, May 1993, pp.145-181.



working wholly or partly in the name of the foreign company, and where the rules or the conditions that organise the commercial and industrial relationship between the foreign company and its agent are different from those that regulate the relationship between independent establishments.<sup>1605</sup> Egyptian income tax law considers that the control test does not represent sufficient evidence that the controlled company is a permanent establishment. In other words, if a resident company is a tax resident in Egypt and it is controlled by a non-resident company, this control does not mean that the resident company is a permanent establishment in Egypt for the other company.

It appears that the permanent establishment definition under Egyptian tax law is similar to the definition provided in Art. 5 of the OECD Model, and since the CCCTB Directive strictly follows the wording of Art. 5 in respect to this definition,<sup>1606</sup> it can therefore be said that Egyptian tax law is compatible with the CCCTB Directive in terms of the permanent establishment definition.

#### **6.4.4.2 Taxation of non-residents – withholding taxes on passive income**

As said, non-resident company that does not have a branch or permanent establishment in Egypt is liable to tax on its Egypt-sourced income and capital gains only.<sup>1607</sup> In this case, income tax is generally imposed by way of final withholding tax, at various rates depending on the type of income. Income paid to non-residents, such as interest, royalties, services fees, and in remuneration of sportsmen's or artists' activity from their Egypt source are subject to final withholding taxes in Egypt.<sup>1608</sup> In this respect, the tax liability arises upon accrual of the income by a resident company or the permanent establishment of a non-resident company. Egypt does not levy withholding taxes on dividends,<sup>1609</sup> but Egyptian tax treaties provide for reduced withholding taxes for interest and royalties.

##### **6.4.4.2.1 Dividends**

Under Egyptian law, dividends distributed by resident companies are not subject to withholding tax, regardless of whether it is paid to residents or non-residents in Egypt.

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<sup>1605</sup> Art. 5 of Executive Regulation of the Income Tax Law no. 91 of 2005, Decree No. (91) of 2005

<sup>1606</sup> Art.5 of the CCCTB Directive.

<sup>1607</sup> Art. 4 of the Income Tax Law No. 91of 2005.

<sup>1608</sup> Art. 56 of the Income Tax Law No. 91of 2005.

<sup>1609</sup> Art. 31(4) of the Income Tax Law No. 91of 2005.

This is because the dividends are paid out of corporate profits which are taxed under the ordinary tax rules.<sup>1610</sup> As mentioned in Chapter 4, foreign dividends received by a CCCTB taxpayer are exempt from tax, meaning that dividends paid by Egyptian subsidiary to a CCCTB company would not be subject to tax in either jurisdiction, which would result in double non-taxation. In this case, the CCCTB's switch-over mechanism would be of great assistance: by means of a switch-over from the exemption method to the credit one, the income in question would be subject to tax in the hands of the CCCTB taxpayer as it is under-taxed in the Egyptian jurisdiction.<sup>1611</sup> Therefore, it can be submitted that under the CCCTB Directive and Egyptian domestic tax law, the tax treatment of dividends which are paid by an Egyptian company to a CCCTB taxpayer does not raise any incompatibility. However, Egyptian tax treaties with EU-Member States do not contain a switch-over clause as drafted in the CCCTB Directive, which means that a switch-over clause would conflict with Egyptian tax treaties.

#### **6.4.4.2.2 Interest**

Under Egyptian law, interest derived by non-resident companies is generally subject to withholding tax on the gross amount at the rate of 20%.<sup>1612</sup> Nonetheless, the withholding tax rate can be limited or reduced according to a tax treaty concluded between Egypt and other contracting states. There is an exemption from the nominal 20% withholding taxes on interest. One exemption addresses the interest on loans and credit facilities received by the government, local authority units and other public legal entities from sources outside Egypt. Moreover, the interest paid by public sector companies, the public business sector and the private sector are also not subject to withholding tax on condition that the loan or the facility term lasts for three years at least.<sup>1613</sup>

Debit interest on loans that are used in the company's activity is deductible from Egyptian companies' tax base after deducting the exempted credit interest.<sup>1614</sup> Nevertheless, the deductible interest is restricted to the interest rate which does not

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<sup>1610</sup> Art. 31(4) of the Income Tax Law No. 91 of 2005.

<sup>1611</sup> Art. 73 of the CCCTB Directive.

<sup>1612</sup> Art. 56 of the Income Tax Law No. 91 of 2005.

<sup>1613</sup> *Ibid.*

<sup>1614</sup> Art. 23(1) of the Income Tax Law No. 91 of 2005.

exceed double the credit and discount rate as determined by the Central Bank of Egypt.<sup>1615</sup>

#### **6.4.4.2.2.1 Thin capitalization rules**

In addition, another rule restricts the deductibility of interest paid to foreign related entities if the payer's debt-to-equity ratio is too high, i.e. the concept of 'fixed debt to equity ratio' is adopted by the Egyptian tax law. The maximum debt-to-equity ratio is determined by the tax law as 4:1.<sup>1616</sup> In effect, where the financial statements which are prepared pursuant to the Egyptian accounting standard show that the debt exceeds such ratio, the excess interest is not accepted by the Tax Authority as a deductible expense. This thin capitalisation rule is designed to prevent too high a percentage of Egypt business profits from being paid out as deductible interest to controlling foreign shareholders. However, this rule is not applicable to banks and insurance companies nor to the companies which are carrying out financial activities.<sup>1617</sup>

#### **6.4.4.2.3 Royalties**

Under Egyptian law, royalties<sup>1618</sup> that are paid by a resident in Egypt to a non-resident are subject to 20% withholding taxes on the gross amount of such payments. The royalties amount, which is paid abroad in respect of a design or of know-how rights for serving the industry, is exempted from the above withholding tax rate.<sup>1619</sup> The 20% tax rate, however, does not apply where a lower tax treaty rate is available.

#### **6.4.4.2.4 Withholding tax rate in Egyptian tax treaties**

As mentioned, dividends distributed to non-residents are not subject to withholding tax under Egyptian domestic law. Accordingly, the following table sets forth reduced withholding tax rates provided in Egypt's tax treaties which are concluded with EU-Member States for interest and royalties only.

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<sup>1615</sup> Art. 24(4) of the Income tax law No. 91 of 2005.

<sup>1616</sup> Art. 52(1) of the Income tax law No. 91 of 2005

<sup>1617</sup> According to the Ministerial Decree no. 162 of 2006 that is published in official Gazette No. 55, the securitisation and leasing companies are treated for tax purposes as finance companies.

<sup>1618</sup> Under Egyptian income tax law, royalty means payments of any type in return for using or the right to use copyrights connected to a literary, artistic, or scientific work, comprising cinema movies, and the use of any patent, trademark, design, plan, formula, or secret process, or in return for using or the right to use scientific, commercial or industrial equipment, or information related to scientific, commercial or industrial expertise, see Art. 1 of the Income Tax Law No. 91 of 2005.

<sup>1619</sup> Art. 56 (2) of the Income Tax Law No. 91 of 2005.

<b>Country of recipient</b>	<b>Interest (%)</b>	<b>Royalties (%)</b>
<i>Austria</i>	15	0
<i>Belgium</i>	15	15
<i>Bulgaria</i>	12.5	12.5
<i>Cyprus</i>	15	10
<i>Denmark</i>	15	20
<i>Finland</i> <sup>1620</sup>	15	20
<i>France</i>	20	15
<i>Germany</i>	15	15
<i>Greece</i>	15	15
<i>Hungary</i>	15	15
<i>Italy</i>	20	15
<i>Malta</i>	10	12
<i>Netherlands</i>	12	12
<i>Poland</i>	12	12
<i>Romania</i>	15	15
<i>Sweden</i>	15	14
<i>Spain</i>	10	12
<i>United Kingdom</i>	15	15

**Table 2: Withholding tax rates in Egyptian tax treaties**

This table shows that the reduced withholding tax rates on interest and royalties in Egyptian tax treaties with CCCTB Member States vary widely, ranging from 20% down to 0%. Interest and royalties are taxed in Egypt at different withholding tax rates. Under the CCCTB Directive, these types of payments are taxable in the recipient CCCTB Member State, but a foreign tax credit is given for Egyptian withholding taxes on interest and royalties up to the corporate tax rate of the respective CCCTB Member State, i.e. the ordinary credit method. As shown above, under the vast majority of

<sup>1620</sup> This tax rate is according to the Egyptian domestic tax law.

Egypt-EU Member States tax treaties, where interest and royalties that derived from Egypt are taxable in the EU-Member State concerned, for double taxation elimination purposes the latter provides for a tax credit for withholding taxes that are imposed on this income in Egypt up to its corporate tax rate. This discloses that taxing interest and royalties that are sourced in Egypt, and preventing double taxation by means of the ordinary credit method under the CCCTB Directive, is consistent with Egypt's domestic tax law and tax treaties.

Where the CCCTB taxpayer who receives interest and royalties from an Egyptian source is a CCCTB group member resident in one Member State, the interest and royalties received are consolidated and apportioned among the group members resident in other Member States. Egypt as a source country would object to the apportionment of interest and royalties income. This would happen when the income that benefits from reduced withholding taxes rates (and accordingly less relief by credit is paid by the residence state) on the basis of its bilateral tax treaty with the residence Member State of the group member is flowing in part to other group members in other Member States with which Egypt has tax treaties not providing for such reduced withholding taxes rate.

#### **6.4.4.2.5 Tax-sparing clause in Egypt's tax treaties and the CCCTB system**

As outlined above,<sup>1621</sup> a tax-sparing mechanism is contained in most of the tax treaties concluded between Egypt and EU-Member States.<sup>1622</sup> Under this clause, most of the Member States "spare" the tax that they would have normally imposed on the low-taxed or untaxed income earned by their company resident in Egypt. In doing so, they grant foreign tax credits equal to the tax that would otherwise have been exigible in Egypt.<sup>1623</sup> Since dividends income derived from Egypt by a CCCTB taxpayer is not taxable in Egypt and is also exempted in the recipient Member State, this would not raise any conflict with the tax-sparing clause incorporated in the tax treaty between Egypt and the relevant Member State. However, since such income will be taxable under the CCCTB switch-over clause as it is low-taxed in Egypt, the switch-over clause will contradict the tax-sparing mechanism. Moreover, interest and royalties which are received from Egypt

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<sup>1621</sup> See section 6.3.3.3.2.

<sup>1622</sup> These tax treaties included those treaties between Egypt-Italy(Art.23); Egypt-UK(Art.22); Egypt-Romania(Art.24); Egypt-Bulgaria(Art. 23);Egypt-Sweden(Art.23(2));Egypt-Belgium(Art.23);Egypt-Hungary(Art.23).

<sup>1623</sup> See for example Egypt-Italy Tax Treaty, Art.23 (4).

are taxed in the recipient Member State, but subject to the ordinary credit method. However, according to the tax-sparing clause in Egyptian tax treaties, if such income is granted tax incentives in the form of exemption or tax reduction pursuant to the Egyptian Law No. 43 of 1974 as amended by Law No. 23 of 1977, then when granting a credit for the foreign tax, the foreign tax which has been exempted or reduced will be deemed to be paid in Egypt. As the CCCTB Directive provides for the ordinary credit method, i.e. the allowable credit will be equal to the amount of income tax paid in Egypt, a conflict arises between the ordinary credit method and the tax-sparing clause included in the Egypt-Member States' tax treaties.<sup>1624</sup> Therefore, as suggested in the previous chapter, the CCCTB Member States should continue applying the tax-sparing clause vis-à-vis Egypt.<sup>1625</sup>

#### **6.4.5 Corporate groups**

For corporate income tax purposes, associated or related enterprises in a group are taxed individually.<sup>1626</sup> Unlike several other countries,<sup>1627</sup> Egyptian law does not comprise the 'group assessment concept', under which affiliated companies can file one consolidated return for the losses of one company to be offset against the profits of other companies in the same group.<sup>1628</sup>

##### **6.4.5.1 Transactions of related parties**

Under the Egyptian income tax law, taxpayers are deemed to be related when they have a relationship that may influence the calculation of the tax base.<sup>1629</sup> More precisely, where a person or a corporation participates directly or indirectly in the control or capital of another company, the two parties will be regarded as associated enterprises. Participation in control means a right to hold at least 50% of voting rights. Participation

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<sup>1624</sup> See for example, Egypt-Poland treaty (1996) Art.24; Egypt-Cyprus tax treaty (1993) Art.23; Egypt-Denmark treaty (1989) Art.23; Egypt -Greece treaty Art.24; Malta (1999) Art.23, and Slovakia (2004), Art.23; Egypt-Italy(Art.23); Egypt-UK(Art.22); Egypt-Romania(Art.24); Egypt-Bulgaria(Art. 23);Egypt-Sweden(Art.23(2));Egypt-Belgium(Art.23);Egypt-Hungary(Art.23).

<sup>1625</sup> See Chapter 5, section 5.4.4.

<sup>1626</sup> See Book three of the Income Tax Law No. 91 of 2005.

<sup>1627</sup> For some example regarding countries that have companies group assessment principle see Dieter Endres, 'The Concept of Group taxation: A Global Overview', *Intertax*, Vol 31, No, 10, 2003, pp.349-352.

<sup>1628</sup> Guglielmo Maisto, *International and EC Tax Aspects of Groups of Companies* (IBFD, 2008), p.56.

<sup>1629</sup> Art.1 of the Income Tax Law No.91 of 2005.

in the capital means a right of ownership of at least 50% of the value of shares. For the purposes of applying the above rule, husband, wife, descendants and ascendants are regarded as related parties.<sup>1630</sup> In principle, an associated enterprise under the Egyptian tax law follows the wording of Art. 9 (1) of the OECD Model; it even goes beyond the OECD definition and requires a minimal ownership of 50% capital or a holding of 50% voting rights. Nevertheless, unlike the OECD Model, Egyptian tax law does not require ‘management participation’ as a criterion for the definition of an ‘associated enterprise’.<sup>1631</sup> By comparing the CCCTB’s associated enterprise definition with Egypt’s one, the ‘related parties’ definition under the CCCTB Directive follow the same criteria, i.e. control, capital and management, as provided in Art.9 (1) of the OECD Model, but it provides for fixed thresholds in respect of control (a holding exceeding 20% of the voting rights), and capital (a right of ownership exceeding 20% of the capital).<sup>1632</sup>

Notably, the control and ownership threshold required under the CCCTB Directive is lower than ownership requirements under Egyptian tax law. Therefore, certain entities would be considered as an associated enterprise pursuant to Egyptian tax law, but under the CCCTB Directive they would be treated differently. In other words, under the CCCTB Directive, commercial and financial transactions carried out between associated enterprises will be priced at arm’s length, whereas these transactions will be recognised as transactions carried out between independent companies according to Egyptian tax law. In order to avoid this overlap and hence the escape of the arm’s length principle, Egypt should amend the ownership and control threshold to be consistent with the CCCTB system.

#### **6.4.5.2 Transfer pricing under the arm’s length principle**

Historically, there was no specific legislation in Egypt restricting transfer pricing or associated enterprises’ transactions. However, as part of the 2005 tax reform, transfer pricing rules were introduced for the first time in Egypt through the Income Tax Law No.91 of 2005. Under this law, the transactions of the related parties have to be priced

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<sup>1630</sup> Art.1 of the Income Tax Law No.91 of 2005.

<sup>1631</sup> Art. 9(1) (b) of the OECD Model.

<sup>1632</sup> Art.78 (2) of the CCCTB Directive.

at arm's length.<sup>1633</sup> Moreover, the Egyptian Tax Authority (ETA) – specifically, its newly established Transfer Pricing Division (TPD) – issued the first general Transfer Pricing Guidelines in Egypt. These Guidelines have been prepared in association with the OECD, and though Egypt is not an OECD member, they are modelled on the OECD ones.<sup>1634</sup>

The main objective of Egypt's transfer pricing provisions is to ensure that any intra-group financial and commercial transactions in which an Egyptian associated enterprise participates are conducted according to the arm's length prices, and also that the relevant tax base reflects the economic contribution of the Egyptian associated enterprise,<sup>1635</sup> i.e. the fair distribution of the tax base of the affiliated companies between Egypt and the other countries. However, the taxation of transfer pricing is considered to be one of the most complex aspects of international taxation.<sup>1636</sup> Therefore, it may be of critical importance to explore the basic concepts of transfer pricing according to the income tax law and the Guidelines of transfer pricing in order to consider Egypt's position in relation to the OECD Transfer Pricing rules.

As mentioned, the Transfer Pricing Guidelines have been introduced to Egypt only recently,<sup>1637</sup> and they contain five chapters and illustrative examples on the main issues of transfer pricing. These include the basis of the arm's length principle and its practical application, comparability analysis, the transfer pricing methods, and documentation and other practical considerations. Taxpayers are prompted to follow these guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle. The guidelines are also intended to rule on the resolution of transfer pricing cases in mutual agreement proceedings.<sup>1638</sup>

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<sup>1633</sup> Art. 30 of the Income Tax Law No.91 of 2005.

<sup>1634</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (Paris OECD, 1995).

<sup>1635</sup> Transfer Pricing Guidelines, A guide to the application of Article (30) of the income tax law No.91 of 2005, Ministry of finance, Egyptian Tax Authority (ETA), p.12.

<sup>1636</sup> For more exposition of the basic issues of transfer pricing see for example Plasschaert, S., Transfer Pricing and Taxation in United Nations Library on Transnational Corporations, Vol. 14.

<sup>1637</sup> The guidelines are realised at the end of 2010, it is considered as a unique guidelines because they are the first of their kind to be issued in Arabic language (accompanied by an English version). Accordingly it is expected that they will be a model for guidelines for other Arabic-speaking countries, making their publication an important regional event.

<sup>1638</sup> Since the Transfer Pricing is a topic that has been recently introduced in Egypt, it was acknowledged by the ETA that in order to taxpayers to be able to put these principles into practice they will need an adequate time to familiarise with concepts behind such topic. Consequently, it has been decided by the



#### 6.4.5.2.1 The arm's length principle

Generally speaking, the arm's length principle lies in the 'Separate Entity Approach', which means that each affiliated company in a group is treated for tax purposes as a separate entity and taxed individually on the basis that it conducts business with other group members at arm's length. In fact, the separate entity approach and arm's length principle are internationally accepted in the area of international taxation.<sup>1639</sup> For Egypt this means that each company within a group of companies has to provide separate accounting for its intra-group transactions.<sup>1640</sup>

The income tax law states that where affiliated companies are conducting commercial or financial transactions on conditions different from those established for conducting businesses between independent parties.<sup>1641</sup> The Egyptian Tax Authority (ETA) has the right to calculate the taxable income on the basis of an arm's length price; especially if the conditions set for the transaction between the associated enterprises results in a reduction of the tax base or in a shifting of the tax burden from the taxable company to an exempt or non-taxable one.<sup>1642</sup> This is consistent with the arm's length standard formulated in Art. 9 (1) of the OECD Model, which seeks the elimination of the effect of any ownership relationship between associated enterprises, which can be an artificial profit-shifting within multinational enterprises.<sup>1643</sup>

The rationale behind the adoption of the arm's length principle in Egypt is that it constitutes the most appropriate and reliable method for the determination of the amount of income attributable to Egypt's operations in intra-group transactions.<sup>1644</sup>

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ETA that "Egypt's Transfer Pricing Guidelines" will be issued in a series of parts, and to focus in the first part on the main issues that arise in the area of transfer pricing. Next parts of "Egypt's Transfer Pricing Guidelines" will deal with other issues such as the application of the arm's length principle to transactions involving intangible property, intra-group services, Cost Contribution Arrangements (CCAs), and Advance Pricing Arrangements (APAs), see Transfer Pricing Guidelines, A guide to the application of Article (30) of the income tax law No.91 of 2005, Ministry of finance, Egyptian Tax Authority (ETA), pp.40-42

<sup>1639</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (Paris OECD, 1995), 2009 edition, p.28

<sup>1640</sup> Art. 9 and 7 of the OECD Model.

<sup>1641</sup> Art. 1 of the Income Tax Law No. 91 of 2005.

<sup>1642</sup> Art. 30 of the Income Tax Law No. 91 of 2005.

<sup>1643</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (2009 edition, Paris OECD, 1995), p.27.

<sup>1644</sup> Anthony Mahon, Egypt introduces first volume of Transfer Pricing Guidelines, 28 February 2011, at <[www.deloitte.com/.../transferpricing/dtt\\_tax\\_tpalert\\_2011>006\\_280211.pdf](http://www.deloitte.com/.../transferpricing/dtt_tax_tpalert_2011>006_280211.pdf)> accessed 15 December 2011.

Moreover, the arm's length principle represents the international standard; hence it reduces the possibilities of double taxation.<sup>1645</sup>

#### **6.4.5.2.2 Transfer Pricing Methods**

In general, different methodologies can be used to establish whether the transactions between associated enterprises are in accordance with the arm's length principle or not. The OECD Transfer Pricing Guidelines provide for two categories of methods. The first one is 'Traditional transaction methods', which includes the Comparable Uncontrolled Price (CUP), Resale Price Method (RPM) and Cost Plus Method (CPM). The second one is 'transactional profit methods', which includes the Profit Split Method (PSM) and Transactional Net Margin Method (TNMM).<sup>1646</sup>

Under Egypt's income tax law, there are three methods for the establishment of the arm's length prices as well as the hierarchy for using these methods.<sup>1647</sup> The first method, which is given the highest priority, is the CUP. Under this approach, the price of transactions on goods and services between affiliated companies is specified on the basis of the price of the same goods and services as if they were being carried out between the affiliated company and independent enterprises. Egypt's tax law emphasizes some factors which can be considered when conducting this comparability: these factors include the legal conditions to which every party in the contract is committed, market circumstances, and the special circumstances of the transaction.<sup>1648</sup> Since this method involves a comparison between the prices charged in controlled transactions carried out between associated enterprises with the prices charged in uncontrolled transactions undertaken between independent enterprises, it is the most direct way to establish whether the conditions imposed between associated enterprises are at arm's length. This is because the difference in the price of controlled transactions

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<sup>1645</sup> Transfer Pricing Guidelines, A guide to the application of Article (30) of the income tax law No.91 of 2005, Ministry of finance, Egyptian Tax Authority (ETA), p.13.

<sup>1646</sup> For a detailed explanation of these methods see OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (2009 edition, Paris OECD, 1995), p.51 et seq.

<sup>1647</sup> Egypt's income tax law No.91 of 2005 refers to the Executive Regulations regarding transfer pricing methods. According to the Executive regulations of the income tax law, the application of the arm's length by the affiliated companies in their transactions is to be verified by the Egyptian Tax Authority (ETA) in respect to commercial or financial transactions carried between such associated enterprises, particularly the exchange of goods, services, raw material, capitalized equipment, and the distribution of shared expenses, royalty interests, see Art. 38 of Executive Regulation of the Income Tax Law no. 91 of 2005, Decree No, (991) of 2005.

<sup>1648</sup> Art. 39 of Executive Regulation of the Income Tax Law no. 91 of 2005, Decree No, (991) of 2005.

from the price in an equivalent uncontrolled transaction can normally be traced directly to the condition of dealings imposed between independent enterprises. Moreover, the CUP method would result in the best outcome when it is applied to transactions that involve commodities, raw materials, agricultural products, chemical base products, and financial products. Although the CUP method has the first priority in the determination of the arm's length, in the event that the requested information is not available to apply such method, or when the taxpayers prove that the implementation of the CUP method is unlikely to produce the most precise measures of an arm's length result for intra-group transactions, such taxpayers are required to use one of the other two methods, namely, RP and CP.<sup>1649</sup>

The second method is the *Resale Price Method (RPM)*. Under this method, the price of goods or services which is transferred between associated enterprises is to be determined on the basis of the resale price of the goods and services sold to an independent third party, after deducting a percentage which represents a reasonable gross margin to the reseller of such goods or services. The gross margin is determined on the basis of the gross margin earned by the same seller in comparable uncontrolled transactions with independent enterprises. Furthermore, the gross margin may be determined on the basis of the gross margin earned by an independent enterprise in a comparable enterprise.<sup>1650</sup>

It is suggested that the Resale Price method would produce the best results when it applies to marketing and distribution operations. Moreover, the above definition is similar to the OECD Transfer Pricing Guidelines in respect to the Resale Price (RP) method and Resale price margin.<sup>1651</sup>

The third method to be applied in the Egyptian tax law is 'Cost Plus' (CP):

According to this method, the price of goods or services, transferred between associated enterprises, is to be determined on the basis of the total cost of the goods and services adding a certain percentage as a gross markup in favour of the supplier or the service

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<sup>1649</sup> Transfer Pricing Guidelines, A guide to the application of Article (30) of the income tax law No.91 of 2005, Ministry of finance, Egyptian Tax Authority (ETA), pp.40-42.

<sup>1650</sup> Art. 39 of Executive Regulation of the Income Tax Law No. 91 of 2005, Decree No, (991) of 2005.

<sup>1651</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (2009 edition, Paris OECD, 1995), p.55 et seq.

provider, [and] such a markup is to be determined on the basis of the cost plus markup earned by the taxpayer in its comparable uncontrolled transactions carried out with independent enterprises, or on the basis of the markup earned by another independent enterprise in comparable uncontrolled transactions.<sup>1652</sup>

This method is most workable when it applies to intra-group transactions which involve the sale of semi-finished goods, especially where a joint facility agreement or long term buy and supply is the basis for such transactions. The definition of the ‘Cost Plus (CP)’ method and the ‘Cost Plus Mark Up’ one follow the OECD Transfer Pricing Guidelines in this regard.<sup>1653</sup>

The Egyptian law refers to other methods described by the OECD Transfer Pricing Guidelines or any other method appropriate for the taxpayer in case of failure to apply any of the preceding three methods explained above, i.e. traditional transaction methods.<sup>1654</sup> However, if taxpayers intend to use alternative methods other than the traditional transactional ones, they are required to prove to ETA that the latter kind cannot be applied dependably. This implies that the Transactional Profit methods will be used prior to any other alternative. The underlying concept of the Transactional Profit methods is the presumption that profit arising from a controlled transaction is a relevant indicator of whether the transaction was affected by conditions that differed from those that would have been made by an independent enterprise in otherwise comparable circumstances, thus profits arising from certain controlled transactions are examined under these methods.<sup>1655</sup>

The two most commonly accepted methods which are endorsed by the OECD Transfer Pricing Guidelines are the Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM). These two methods are similar, but the key difference between them is that the profit split method is applicable to all members involved in a controlled

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<sup>1652</sup> Art. 39 of Executive Regulation of the Income Tax Law No. 91 of 2005, Decree No, (991) of 2005.

<sup>1653</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (Paris OECD, 1995), 2009 edition,p.59 et seq.

<sup>1654</sup> Art. 40 of Executive Regulation of the Income Tax Law no. 91 of 2005, Decree No, (991) of 2005.

<sup>1655</sup> OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (Paris OECD, 1995), 2009 edition,p.67.

transaction, whereas the transactional net margin method is applied only to one member.<sup>1656</sup>

The Egyptian Transfer Pricing Guidelines are applicable to the transactions between an associated enterprise resident in Egypt as well as to the transactions carried out between an enterprise resident in Egypt and its non-resident associated enterprises, i.e. related parties resident in the CCCTB Jurisdiction. Nonetheless, these guidelines are not applicable to transactions within the same legal entity, such as those carried out between a head office and its permanent establishments.<sup>1657</sup>

Overall, unlike most Middle Eastern countries, Egypt currently has detailed transfer pricing guidelines addressing the application of the 2005 transfer pricing provisions.<sup>1658</sup> It can be noticed that Egypt's transfer pricing rules follow the OECD Transfer Pricing Guidelines. Moreover, Egypt in its tax treaties with the vast majority of the EU-Member States follows Art. 9 of the OECD Model and applies the arm's length principle on transactions between associated enterprises.<sup>1659</sup> On the other hand, under the CCCTB system, consolidation and formulary apportionment is limited to the water's edge of the EU, i.e., there is no elimination of intra-group transactions between the CCCTB consolidated companies and Egyptian companies. Hence, separate accounting and the OECD Transfer Pricing Guidelines would still be applicable for dealings between such companies. This means that adjustments and corresponding adjustments will need to be made between associated enterprises including CCCTB group companies and Egyptian group companies. Certainly, in relation to Egypt rights and obligations arising from tax treaties, particularly transfer pricing arrangements under the Article equivalent to Art. 9

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<sup>1656</sup> Anthony Mahon, Egypt introduces first volume of transfer pricing guidelines, 28 February 2011, at <[www.deloitte.com/.../transfer-pricing/dtt\\_tax\\_tpalert\\_2011-006\\_280211.pdf](http://www.deloitte.com/.../transfer-pricing/dtt_tax_tpalert_2011-006_280211.pdf)> accessed 15 December 2012.

<sup>1657</sup> The ETA intends to provide separate regulations in respect to the tax treatment of permanent establishments including the pricing of dealings between a head office and its permanent establishments located in Egypt or overseas. Furthermore, the main objective of the guideline is to provide a practical guide rather than a descriptive one; it provides the taxpayers with guidance of the application of the arm's length principle in pricing their intra-group transactions and discuss the documentation that taxpayers are advised to develop in order to demonstrate to the ETA their compliance with such principle, see Transfer Pricing Guidelines, A guide to the application of Article (30) of the income tax law No.91 of 2005, Ministry of finance, Egyptian Tax Authority (ETA), p.6.

<sup>1658</sup> See PWC, Transfer Pricing Perspectives: A selection of articles tackling the issues of the transfer pricing lifecycle, p.6, available at <[www.pwc.com/transferpricingperspectives](http://www.pwc.com/transferpricingperspectives)> accessed 10 January 2013.

<sup>1659</sup> See for example tax treaties concluded between Egypt and Finland, Italy, France, Greece, Bulgaria, Sweden, Belgium, Spain, the UK, Romania, Austria, Cyprus, Poland and the Netherlands.

of the OECD Model would not be overridden by the CCCTB Directive, especially formulary apportionment, which is provided in Art. 86 of the CCCTB Directive.

Therefore, it seems to be imperative for Egypt to examine how to co-ordinate and combine formulary apportionment with the arm's length principle, and to ensure that the application of separate accounting for transactions between the CCCTB group and Egyptian affiliates does not lead to double taxation at the expense of the latter.

## **6.5 Conclusion**

This chapter examined the impact of the international taxation rules of the CCCTB on corporate tax practice in Egypt. It was seen that in addition to the very close physical location of Egypt to Europe Egypt and the EU-Member States have a very close mutual relationship, especially in relation to FDI, trade and the number of double tax treaties; the volume of trade and FDI between the two parties has reached a high level during the past few years. The chapter discussed the main structures of the Egyptian tax system, including indirect and direct taxation. It mainly focused on direct taxation, which in turn is divided into individual income tax and corporate income tax. The main focus of this chapter was the examination of the compatibility of the CCCTB rules with the international corporate tax rules in Egypt. Generally, it showed that the CCCTB rules are consistent with corporate tax practice of Egypt. However, the CCCTB-formulary apportionment conflicts with the arm's length principle applicable in Egyptian tax treaties. Furthermore, the CCCTB switch-over clause would conflict with the tax-sparing clause contained in most of the Egypt-EU-Member States tax treaties. The apportionment of the foreign tax credit between the CCCTB-Member States will contradict Egypt tax treaties. Overall, the CCCTB system can operate in relation to Egypt at least in the short term.

## **7 Conclusions and Recommendations**

### **7.1 Conclusion**

The preceding chapters have examined the international aspects of the European CCCTB system and their potential interactions with the corporate tax systems of third countries. Chapter 1 set out the parameters for the research presented in this thesis. Chapter 2 established that implementing the CCCTB in the European Union would significantly reduce corporate tax obstacles in the EU, and would thereby contribute positively to the achievement of the goals set by Lisbon Strategy, i.e. achieving the enhancement of growth and jobs and competitiveness within the EU. In chapter 3 it was revealed that limiting the territorial scope of the CCCTB consolidation and formulary apportionment to the boundaries of the EU (i.e. the water's edge approach) and taxing the worldwide income of a CCCTB taxpayer is workable and justifiable. It was also argued that a proper functioning of the CCCTB system in relation to third countries requires that the water's edge approach be associated with common rules for the elimination of international double taxation and the protection of the consolidated tax base. Chapter 4 concluded that the unilateral common measures incorporated in the CCCTB Directive (including the exemption method associated with the switch-over clause and the ordinary credit method) would be effective in eliminating double taxation and double non-taxation in relation to third countries, and that the CCCTB's anti-abuse rules including GAAR, CFC rules, and thin capitalisation rules would sufficiently protect the common tax base against tax-abuse. However, these measures would be likely to conflict with the current OECD-based tax treaties concluded between the CCCTB-Member States and third countries. Chapter 5 examined in detail the potential conflicts referred to in chapter 4, and established that the international taxation rules under the CCCTB system (including the anti-abuse rules and the exemption and credit method) are not consistent with several provisions of the OECD-based tax treaties concluded between potential CCCTB-Member States and third countries. Chapter 6 examined the compatibility of the international aspects of the CCCTB with corporate tax practice in Egypt as a practical example, and confirmed the existence in reality (as opposed to hypothetically or theoretically) of the generic problem highlighted in chapter 5 - that is, that there is a real conflict between the CCCTB international taxation rules

and a number of provisions of OECD Model-based bilateral tax treaties concluded with EU Member States.

The conclusions, from the foregoing analyses, are that, in spite of the fact that the ordinary credit and exemption methods provided in the CCCTB Directive would be effective in eliminating international double taxation in relation to third countries, and that the CCCTB anti-abuse rules would be effective in protecting the common tax base and in eliminating double non-taxation, the CCCTB's unilateral measures would have problematic conflicts with a number of important provisions of bilateral tax treaties, based on the OECD Model, concluded between the potential CCCTB-Member States and third countries. While these conflicts would not render the operation of the CCCTB system in relation to third countries impossible in the short-term, they would weaken the CCCTB's objectives and render the CCCTB an ill-functioning system. Therefore, these conflicts need to be addressed. For this purpose, some recommendations will be made. These recommendations will address such conflict mainly from a theoretical perspective, but a practical solution will be suggested where the theoretical one is not achievable in practice.

## **7.2 Recommendations**

The first recommendation for addressing the incompatibilities just referred to is for the European commission to clarify in specific ways (see below for details) the meaning of certain provisions of the CCCTB Directive. Some other provisions of the CCCTB Directive need to be reconsidered and some legislative gaps in the CCCTB Directive need to be filled, as detailed in the discussions that follow below.

First, the CCCTB Directive does not make a formal link between the CCCTB and IFRS, which is used by most of the EU companies as the basis for computing their corporate tax base. Under the CCCTB companies will continue drawing up their individual accounts using existing financial accounting rules or using local GAAP, in respect of matters where uniform treatment is not regulated by the CCCTB Directive. In this respect, Member States can bring the financial accounts into line with the CCCTB rules by using adjustments. However, the Directive does not lay down rules for these adjustments between all the different domestic GAAPs. Consequently, it will be up to



each Member State to decide how it will implement the rules, which in turn would undermine the uniformity objective of the CCCTB. Therefore, it is recommended that the CCCTB Directive should provide a comprehensive set of general principles and rules that will include all aspects of calculating the corporate tax base, i.e. the rules needed to calculate the profits and losses of a CCCTB taxpayer.<sup>1660</sup>

Secondly, in order for a third-country company to opt for the CCCTB system, it has to be subject to one of the corporate taxes laid down by the CCCTB Directive. In this respect, the CCCTB Directive does not clarify the ‘subject to tax’ test. The wording of the relevant provision should be revised in order to engender greater clarity. For this purpose, it is recommended that the wording of the equivalent article in the Parent-Subsidiary Directive, which states that the company must be subject to one of the taxes therein without ‘the possibility of option’, or the wording of the parallel article in the Interest and Royalties Directive which requires that ‘the company is subject to tax without being exempt’, be adopted. This issue is discussed in more details in chapter 3.<sup>1661</sup>

Thirdly, applying the formulary apportionment within the consolidated group, while such a group remains connected to the outside world via separate accounting and the arm’s length principle, will open the door to profit-shifting opportunities and tax abuse. Although the arm’s length concept provided in the CCCTB Directive, which is applicable only in relation to third countries, is consistent with Arts. 7(2) and 9 of OECD, as discussed in chapter 5,<sup>1662</sup> it will increase complexity and engender high compliance costs, as the CCCTB Directive does not provide for common transfer pricing rules and also because the coexistence of such concept with CCCTB-Formulary apportionment which applies only within the EU boundaries. Thus, it is recommended that the CCCTB should coordinate its formulary apportionment with the arm’s length principle. This can be done by improving and developing current OECD guidelines on the arm’s length principle into a profit-split mechanism, and including it in the CCCTB Directive as a common approach applicable to third countries. This proposed solution is

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<sup>1660</sup> For more details on differences between the CCCTB Directive and national tax rules in respect of the calculation of taxable income, see Chapter 2.5.1.1, and, generally, Christoph Spengel, York Zöllkau (Eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income - An International Comparison* (Springer 2012), p.98 et seq.

<sup>1661</sup> See Chapter 3.3.1.

<sup>1662</sup> See Chapter 5.5.1.

expected to be workable because the profit-split method is similar to the CCCTB-formulary apportionment in some aspects.<sup>1663</sup>

Fourthly, in the context of the exemption method, which is discussed in chapter 4,<sup>1664</sup> the CCCTB Directive uses the expression ‘*revenues*’, while, in other provisions, the terms ‘*income*’ or ‘*proceeds*’ are employed. Considering that revenue is a positive gross amount, this indicates that the CCCTB should not permit a negative exemption with progression. In this respect, the CCCTB Directive should state that the CCCTB-Member States have the right to include the foreign source income items, both positive and negative, in the taxpayer’s tax base for the purpose of determining the applicable tax rate.

Fifthly, the analysis in chapter 4 revealed that the CCCTB Directive does not explain what constitutes a ‘special regime’ which is required for the switch-over clause application.<sup>1665</sup> It is suggested that identifying the ‘special regime’ can be done through a list detailing what constitutes a special regime. This list can include the types of provisions granting tax subsidies which qualify as special regimes. For instance the CCCTB Directive can state that providing a special depreciation that reduces the taxable profits by more than 50% is a special tax regime. This list can be published by the European Commission. This approach would support tax certainty and clarity, because the taxpayer can predict when the switch-over clause is applicable. Additionally, the meaning of ‘substantially lower level of taxation’ needs to be specified, i.e. identifiable standards are required for measuring ‘substantially’. In this regard, the 40% threshold incorporated in Art. 73(a) of the CCCTB Directive can be used to measure substantiality.

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<sup>1663</sup> Heinz-Klaus Kroppen, Roman Dawid and Richard Schmidtke, ‘Profit Split, the Future of Transfer Pricing? Arm’s Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective’ and Marco Runkel ‘In Favor of Formulary Apportionment: A Comment on Kroppen/Dawid/Schmidtke: “Profit Split, the Future of Transfer Pricing? Arm’s Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective’ in Wolfgang Schön, Kai Andreas Konrad (eds.) *Fundamentals of International Transfer Pricing in Law and Economics* (Springer 2012), pp.267-295; for details on profit-split method see OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, Para. 2.108 et seq.

<sup>1664</sup> See Chapter 4.3.1.2.

<sup>1665</sup> See Chapter 4.3.1.4.

Sixth, the CCCTB Directive does not provide for foreign tax credit carry-forward in the case of unused tax credit or where the taxpayer who received the foreign income realises an overall loss in the year in which it receives such income and is not subject to tax in the residence Member State. In this case the CCCTB Directive should provide for credit carry-forward as the income received from third countries will be indirectly taxed twice, i.e. firstly in third countries in the year of distribution and secondly in the year in which the consolidated group becomes profitable.

Seventh, in chapter 4<sup>1666</sup> it was established that the CCCTB Directive does not provide detailed provisions on the consolidation of the foreign income, i.e. whether foreign income is included in the tax base of the recipient taxpayer and then consolidated, or is added to the consolidated tax base. Thus it is recommended that the taxable foreign income should not be included in the recipient's tax accounts; it would be better if it is added to the consolidated tax base of the group and then shared out.

Eighth, analysis of the CCCTB's thin capitalisation rules in chapter 4<sup>1667</sup> revealed that the competent authority that is in charge of upholding the thin capitalisation rules, i.e. denying the interest deduction, is not identified in the CCCTB Directive. It is suggested that the right to deny interest deduction should be given to the Member State in which the borrowing company is resident. This would not contradict the existing tax treaties with a third country.

Ninth, as established in chapter 5, the CCCTB Directive does not lay down common rules for withholding taxes on outbound passive income.<sup>1668</sup> But, the outbound payments of passive-type income would need to be treated under a common basis in order to achieve the CCCTB's uniformity objective. Against the endorsement of the elimination of withholding taxes and a reduction in the EU with regard to outgoing interest and dividends, it is recommended that the CCCTB should provide for a common reduced-withholding tax rate on outbound payments equal to the ones prevailing in the current tax treaties concluded with third countries.

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<sup>1666</sup> See Chapter 4.3.1.6.

<sup>1667</sup> See Chapter 4.2.2.3.

<sup>1668</sup> See Chapter 5.5.2.

Tenth, the application of tax-sparing provisions in relation to third countries would raise several difficulties under the CCCTB system, especially if not all CCCTB-Member States apply a tax-sparing clause. In chapter 5<sup>1669</sup> it was suggested that one possible solution for these problems is for the CCCTB-Member States which already have a tax-sparing clause in their tax treaty with a third country to continue applying it towards such country. However, in this case, CCCTB-Member States that do not have a tax-sparing clause in their tax treaties with third countries should share the ‘fictitious’ credit that provided by one CCCTB Member State which has a tax-sparing clause in its tax treaty. This solution can be upheld by including a provision in the CCCTB Directive on the apportionment of the ‘fictitious’ credits. The apportionment can be carried out on the basis of formula apportionment as in the case of actual credit apportionment. In order to avoid the abuse of the tax-sparing provision, the redesign of a common tax-sparing provision based on the criteria provided by the OECD would be an elegant solution.

Eleventh, it is expected that the CCCTB would not be adopted by most Member States, i.e. there would be CCCTB-Member States and non-CCCTB-Member States within the EU. Therefore, distinct rules on the tax treatment of cross-border businesses between the CCCTB-Member States and non-CCCTB Member States should be incorporated in the CCCTB Directive. In this respect, the CCCTB Directive should explicitly state that non-CCCTB Member States will receive a different treatment from third countries. Accordingly, it should be stated in the CCCTB Directive that the specific anti-abuse rules are not applicable between CCCTB-Member States and non-CCCTB-member states, and that, instead, the GAAR applies. This will be consistent with EU law and ECJ case law (see chapter 4). Moreover, in chapter 4, analysis of the CCCTB provisions revealed that the income of an EU-permanent establishment located in a non-CCCTB Member State will always be consolidated. This welcome stance of the CCCTB, but it should be expressly incorporated in the provisions of the CCCTB Directive.

Lastly, in relation to third countries, considering the conflict between the CCCTB rules and third-country tax treaties, the proposed unilateral measures under the CCCTB Directive would at least necessitate bilateral renegotiations of all the treaties concluded

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<sup>1669</sup> See Chapter 5.5.4.

by the Member States, in particular those providing for an exemption method as relief for double taxation, in order to allow them to use the credit method, at least as regards jurisdictions with a more favourable tax system. Moreover, CCCTB provisions allowing EU Member States to apply CFC legislation and thin capitalisation rules should also be incorporated into existing tax treaties, even if the OECD Commentary does not require it, since several Member States consider that CFC legislation and thin capitalisation rules are contrary to the OECD Model. However, the bilateral renegotiation of Member States tax treaties would not do away with all CCCTB problems; some conflicts between the CCCTB rules and third countries tax treaties, such as the conflict related to the apportionment of the foreign tax credit, require adopting a common credit method by all CCCTB-Member states. Therefore, a comprehensive solution is recommended.

The underlying idea of such comprehensive solution is that opting for the CCCTB system by the EU member states implies that they agree on common rules to be applied internationally, such as a method for elimination of double taxation and anti-abuse rules that are applicable towards third countries. In the long-term, therefore, a possible solution for all the above-mentioned problems – i.e. conflict between CCCTB rules and third countries tax treaties provisions – could be the replacement of the tax treaties between CCCTB-Member States and third countries with one tax treaty to be concluded between every third country and all CCCTB-Member States. The OECD Model can be used as starting point for establishing such multilateral tax treaty, i.e. borrowing the OECD model provisions and amending those borrowed provisions that conflict with the CCCTB rules. Moreover, agreeing on a common tax system in the EU would make it the best potential area for the conclusion of a multilateral tax treaty. Taking this action would be similar to the outcome of operating a custom union, under which a group of independent countries at the international level acts as one tax-imposing body, whereas the proposed water's edge system resembles more of a free trade area.

### **7.3 A practical solution for redressing the conflict between the CCCTB international tax rules and third country tax treaties**

It should be pointed out here that this thesis is seeking to provide an optimal solution to the conflict between the international aspects of the CCCTB and corporate tax practice in third countries mainly from theoretical perspective. Thus, the above suggested solution is based on a theoretical assumption, that is, there will be a consensus by the EU Member States on the current form of the CCCTB system. However, the difficulty with the above-mentioned comprehensive solution is that it might not be achievable in practice. Since this research has considered some practical aspects of the CCCTB system such as the reaction of the EU Member States to such system, it is appropriate to suggest a practical approach as follows.

It is established that that the unanimity requirement is a serious obstacle for adopting the CCCTB Directive in the EU. Several governments have in the meantime expressed their opposition to the project of a CCCTB mainly, due to the implications of consolidation and the Formulary apportionment mechanism.<sup>1670</sup> Moreover, the CCCTB Directive was lukewarmly received by the European Council and has so far only been discussed at working party level.<sup>1671</sup> Therefore, it is very unlikely that the CCCTB will be implemented in its current form, and thus the conclusion of multilateral tax treaty is implausible. In other words, as long as there will be no consensus on the CCCTB system in the EU there will be no agreement on a multilateral tax treaty, as such a treaty will be based on the common international aspects incorporated in the CCCTB Directive.

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<sup>1670</sup> For example the governments of The UK, Ireland, Netherlands, Sweden, Malta, Poland, Bulgaria and Romania and Germany announced their rejection to the CCCTB proposal. Although the European parliament has supported the introduction of the CCCTB system, the legislative procedures under Art. 115 of the TFEU make the role of the parliament a consultative one; for more on the reaction of the EU to the CCCTB Directive see Chapter 2.8.3; see Eric C.C.M. Kemmeren, 'CCCTB: Enhanced Speed Ahead for Improvement', EC Tax Review, Vol. 20, 2011, pp. 208-210 at 209; The adopting of the CCTB without consolidation is seen to be necessary as permanent project in the EU (i.e. not as an interim stage) down to the drawbacks of the CCCTB-formulary apportionment. It is concluded that 'Formulary apportionment under the CCCTB is not a convincing alternative to separate accounting and arm's length pricing as it would combine the problems related to the arm's length standard with additional problems resulting from specific drawbacks of the new system and its uneasy co-existence with the persisting system of separate accounting and transfer pricing' see Erik Röder 'Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment', World Tax Journal, June 2012, pp.125-150 at 149.

<sup>1671</sup> Conclusions of the European Council, 24/25 March 2011, p.20, available at <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/co\\_m\\_2011\\_121\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/co_m_2011_121_en.pdf)> accessed 21 May 2013.

### 7.3.1 Two-step approach for addressing the incompatibilities between the CCCTB international tax rules and third country tax treaties

The EU could adopt a Common Corporate Tax Base (CCTB), without consolidation and formulary apportionment, as an interim stage. Accordingly, the CCCTB scheme will be introduced in two phases. The first stage simply involves the substitution of the 27 domestic tax accounting regulations across Member States by a single set of common tax accounting rules, i.e. (CCTB). This would merely consist of the computation of the corporate tax base. The second step is the consolidation of individual group members' tax bases and the subsequent formulary apportionment for allocation of the consolidated tax base; this would be reconsidered at a later stage.<sup>1672</sup>

At the EU level, the introduction of a CCTB as an interim stage would have several benefits. Firstly, a CCTB would be easier to manage due to the omission of the formulary apportionment. This in turn would decrease the need of communication and coordination between the tax authorities of the EU Member States. Moreover, the CCCTB is rejected by some Member States as they expect a reduction in their tax revenues, which would occur under the CCCTB due to cross-border loss utilisation or a different attribution of the tax base according to the application of CCCTB-formulary apportionment.<sup>1673</sup> This possibility of revenue reduction would not exist under a CCTB and thus there will no basis for such Member States to object. Furthermore, a key benefit for taxpayer would be the enhanced transparency of tax calculation between Member States. If the corporate tax base has to be calculated pursuant to common EU-wide regulations, every taxpayer can simply choose the preferential location for its intended investment by comparing just the nominal corporate tax rates of the respective Member States. Under a CCTB differences in effective tax rates would be mirrored more accurately in nominal tax rates than under prevailing corporate tax systems. In other words, competition between Member States to attract investment would greatly

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<sup>1672</sup> Erik Röder 'Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment', *World Tax Journal*, June 2012, pp.125-150 at 149; Christoph Spengel, York Zöllkau(Eds.) *Common Corporate Tax Base (CC(C)TB) and Determination of Taxable Income - An International Comparison* (Springer 2012), pp.8, 10.

<sup>1673</sup> The European Commission admitted that the impact of the CCCTB on the revenues of each Member States is difficult to be predicted, see Communication from the Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)', COM(2011),p.6.

depend on nominal tax rates.<sup>1674</sup> In addition, a CCTB is likely to reduce compliance and administrative costs which result from the diversity of tax systems within the European Union.<sup>1675</sup> Finally, it is submitted that international cooperation and cross-border reorganisation between Member States would be simplified under a CCTB. This is likely to happen because, for instance, the recognition and the measurement of liabilities and assets will be carried out according to common rules in all Member States. Thus, the CCTB would decrease most of administrative costs and the possibilities of double taxation related to cross-border reorganisations.<sup>1676</sup>

On the other hand, under a CCTB, all other tax obstacles on cross-border activities would generally remain. Firstly, the automatic cross-border loss compensation and the removal of distortions caused by limitations of cross-border loss relief will not be achieved. Also, the CCTB will not solve the problem of double-taxation that results from conflicting taxing rights. Moreover, transfer pricing issues would persist under a CCTB system.<sup>1677</sup> In this respect, however, both tax administrations and taxpayers would benefit from the common tax accounting regulations in numerous ways. Most noticeably, knowing that transfer prices are generally computed pursuant to tax accounting principles for the purpose of applying cost-based methods, such as the cost plus method, complexities associated with determining the cost base for cross-border transactions on common rules basis would be significantly alleviated.<sup>1678</sup>

Against this background, although a CCTB (as an interim phase) would not eliminate the entire corporate tax obstacles in the EU in one stroke as under the CCCTB, it, however, would be a significant step towards the CCCTB, and thus may be a promising starting-point for corporate tax harmonization in the EU. Moreover, some studies conducted an international comparison between the regulations for the determination of

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<sup>1674</sup> Charles E. McLure, Jr, 'Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications', in James M. Poterba (ed.) *Tax Policy and the Economy*, vol.22, pp. 151-195 at 164 et seq.

<sup>1675</sup> European Commission, 'Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582 final, p. 11; Ulrich Schreiber, 'The Taxation of Hidden Reserves under the Common Consolidated Corporate Tax Base', *European Taxation*, February 2009, pp. 84-91

<sup>1676</sup> Christoph Spengel, York Zöllkau (Eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income - An International Comparison* (Springer 2012), p.10.

<sup>1677</sup> In a nutshell, the CCTB will not achieve the benefits of the consolidation and formulary apportionment mechanism, for more details on those benefits; see chapter 2.5.2 and 2.6.3.

<sup>1678</sup> Christoph Spengel, York Zöllkau (Eds.) *Common Corporate Tax Base (CC(C) TB) and Determination of Taxable Income - An International Comparison* (Springer 2012), p.10.



taxable income in EU Member states with tax accounting regulations of the CCTB. They generally showed that the CCCTB Directive's set of autonomous tax accounting rules are in accordance with international standards and commonly accepted principles of tax accounting, and that the common corporate tax rules of the CCCTB are not new to the EU Member States.<sup>1679</sup> More specifically, it was shown that the prevailing tax accounting practices of the individual EU Member States are at variance with the CCTB in some aspects.<sup>1680</sup> Nonetheless, such differences are expected to have a minor impact on the actual amount of taxable income as these differences are of a technical nature.<sup>1681</sup> It is submitted that shifting from current tax accounting to a CCTB will have minor impact on EU companies' effective tax burden. Therefore, the study concluded that a CCTB provisions as provided in the CCCTB Directive are suitable to replace the current domestic corporate tax systems of the EU Member States in respect of rules for the calculation of the tax base.<sup>1682</sup> Against this conclusion it can be submitted that a CCTB approach would succeed in the political processes of the EU, i.e., it would be acceptable to most of Member States. In this regard, any CCTB should be compulsory rather than being optional.<sup>1683</sup> Implementing a CCTB without consolidation as an optional system would violate abovementioned advantages of a CCTB and it would lead to unnecessary complications as the CCTB and national corporate taxes of the EU Member States will coexist.

It should be stressed that a CCTB should be applied as an interim stage not as an alternative to the CCCTB because under a CCTB, as said above, major corporate tax obstacles in the EU will remain.<sup>1684</sup> The CCTB as a transitional stage into the CCCTB

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<sup>1679</sup> Christoph Spengel et al. 'A Common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C) TB', World Tax Journal, October 2012, pp. 185-221, at 2017 et seq.

<sup>1680</sup> It is established that these differences are related to the taxation of 'unrealized revenues from financial assets and liabilities held for trading (Art. 23 of the CCCTB Directive); rollover relief for individually depreciable replacement assets (Art. 38 of the CCCTB Directive); tax exemption of portfolio dividends and revenues from the disposal of portfolio shares (Art. 11 of the CCCTB Directive); recognition and measurement of provisions for legal obligations (Art. 25) and pension provisions (Art. 26); pool depreciation of tangible assets with a useful life of 15 years and less at a rate of 25% (Art. 39) and unlimited carry-forward of incurred losses (Art. 43 (1))', see *Ibid.*, p.118.

<sup>1681</sup> Christoph Spengel et al. 'A Common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C) TB', World Tax Journal, October 2012, pp. 185-221, at 2017 et seq.

<sup>1682</sup> *Ibid.*

<sup>1683</sup> Martin J. Boar, 'A few Comments on the CCCTB-Directive', p.4, available at: <<http://ssrn.com/abstract=2012276>> accessed 20 May 2013.

<sup>1684</sup> Some scholars suggested applying an enhanced CCTB as an alternative to the CCCTB on the ground that Formulary apportionment under the CCCTB is not a convincing alternative to separate accounting and arm's length pricing, and that a CCTB can alternative to the CCCTB if certain supplementary common provisions are incorporated to the CCCTB Directive, see Erik Röder 'Proposal for an Enhanced

should not be drawn out. This is because implementing the second step, i.e., consolidation and the apportionment of the consolidated tax base, will put more pressure on the EU Member States to maintain common rules for tax base determination. In other words, if a CCTB is implemented and such implementation is prolonged there will be no need for common tax base as each Member State would calculate the tax base only for its own tax revenue.<sup>1685</sup> Consequently, corporate tax diversity would resurface as Member States' tax authorities would interpret the common rules in different ways or would even introduce different rules adjusting the CCTB provisions, for instance they could introduce incentives such as tax credits. This risk would mainly occur due to fact that some provisions of a CCTB Directive will be subject to interpretation.<sup>1686</sup>

If a CCTB is acceptable to Member States of the EU, a multilateral tax treaty between the CCCTB-Member States and relevant third countries would be achievable in practice. Accordingly, the incompatibilities between the international aspects of the CCCTB and third countries tax treaties will be addressed in a two-step approach. In the first step the multilateral tax treaty would contain provision for eliminating conflicts of the CCTB anti-abuse rules and exemption and credit method with third countries tax treaties and the conflict between switch-over clause and tax-sparing mechanism included in developing third country tax treaties. In the second step of applying the CCCTB Directive, i.e. Consolidation and formulary apportionment, the multilateral tax treaty can be amended to eliminate conflict between the Formulary apportionment and arm's length principle and the problems related to the apportionment of foreign tax credit.

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CCTB as Alternative to a CCCTB with Formulary Apportionment', *World Tax Journal*, June 2012, pp.137 et seq. However, as established earlier in this research under the ongoing literature the scale is tilted in favour of formulary apportionment see Chapter 2.6.3; see also Reuven S. Avi-Yonah, Kimberly A. Clausing, Michael C. Durst, 'Allocating business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split', available at: <<http://ssrn.com/abstract=1317327>> accessed 20 May 2013.

<sup>1685</sup> See <<http://ebookbrowse.com/ccctb-part1-pdf-d321881455>> accessed 22 May 2013.

<sup>1686</sup> See <<http://ebookbrowse.com/ccctb-part1-pdf-d321881455>> accessed 22 May 2013.

### **7.3.2 Elimination of the incompatibilities between the CCCTB rules and Egypt's corporate tax practice**

At the specific third country level, Egypt has been used herein as an example of a third country with close economic and geographical ties to the EU. As regards the compatibility of the CCCTB rules with Egypt's corporate tax practice, the best outcome would be for the EU to establish a multilateral tax treaty that is compatible with CCCTB system, as described above, and for Egypt to join such tax treaty. This approach may be seen as treating the European Union as 'one State', which indicates, from a practical perspective, that it is possible for Egypt to conclude one multilateral tax treaty with the EU rather than renegotiating a large number of bilateral tax treaties. As said above, if the EU Member States agree on a CCTB as a transitional step towards the CCCTB, concluding a multilateral tax treaty by the EU Member States with Egypt as a third country would more easily be achievable, as a CCTB system would not require considerable amendments to the current tax treaties between Egypt and the EU Member States. A close look at the interaction between the CCCTB international tax rules and corporate tax practice in Egypt in chapter 6 reveals that implementing a CCTB system (i.e., without consolidation) in the EU makes such system effective in relation to Egypt. This is because if a CCTB is implemented in the EU the conflicts between such system and Egypt's tax treaties will be narrowed to those that arise between a CCTB switch-over clause and the tax-sparing provisions contained in most of the Egypt-EU-Member States tax treaties and between the CCTB thin capitalisation rules and Egypt tax treaties. In the second step of the CCCTB, the EU can amend the multilateral tax treaty as to accommodate the CCCTB, and Egypt can join such amended treaty to eliminate the conflict between CCCTB-formulary apportionment and arm's length principle which is contained in Egypt tax treaties.

If the suggested multilateral treaty does not materialise, then Egypt should consider adjusting certain provisions in its tax treaties with EU Member States so as to be sensitive to CCCTB concerns. These adjustments should be made to eliminate the conflict between the CCCTB-formulary apportionment and the arm's length principle applicable in Egyptian tax treaties. Secondly, the conflict between the CCCTB switch-over clause and the tax-sparing clause contained in most of the Egypt-EU-Member

States tax treaties should be removed. Finally, the contradiction between the CCCTB provision on the apportionment of the foreign tax credit between the CCCTB-Member States and Egypt tax treaties will need to be eliminated. It is obvious that the renegotiation of a large number of tax treaties would be a cumbersome and time-consuming process – a process that may have to be repeated if there are future changes in the CCCTB. Therefore, such activities on the part of third countries would be problematic.

Overall, it is recommended that the EU should implement a CCTB (without consolidation) as an interim stage, as this would increase the effectiveness of the CCTB via-a-vis third countries and make the task of concluding a multilateral tax treaty in the EU, which would do away with most of the conflicts between the CCCTB rules and third countries corporate tax practice, (the long-term solution) possible.

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